

MISSISSIPPI LAW JOURNAL

ARTICLES

THE CRIMINALIZATION OF JUVENILE JUSTICE:
LEGISLATIVE RESPONSES TO "THE PHANTOM MENACE"
Samuel Marion Davis

CHANGE OF CONTROL BOARD: FEDERAL PREEMPTION OF THE
LAW GOVERNING A TARGET'S DIRECTORS
Samuel C. Thompson, Jr.

THINKING OUT LOUD ABOUT THE MYTH OF *ERIE*:
PLUS A GOOD WORD FOR SECTION 1652
Jerome A. Hoffman

ADVERTISEMENTS AND SPONSORSHIPS IN CHARITABLE CYBERSPACE:
VIRTUAL REALITY MEETS LEGAL FICTION
Darryll K. Jones

COMMENTS

PROPOSALS FOR A FEDERAL PROHIBITION OF INTERNET GAMBLING:
ARE THERE ANY OTHER VIABLE SOLUTIONS TO THIS PERPLEXING PROBLEM?

SELECTIVE DISCLOSURE: "A FENCING MATCH CONDUCTED ON
A TIGHTROPE" AND REGULATION FD—THE SEC'S LATEST
ATTEMPT TO "ELECTRIFY THE TIGHTROPE"

RECENT DECISIONS

CONSTITUTIONAL LAW—FIRST AMENDMENT—APPLICATION OF PUBLIC
ACCOMMODATIONS LAW VIOLATES FIRST AMENDMENT WHEN ORGANIZATION'S
EXPRESSIVE ACTIVITY IS SIGNIFICANTLY BURDENED

CONSTITUTIONAL LAW—FIRST AMENDMENT—GOVERNMENT MUST
DEMONSTRATE THAT THERE IS NOT A LESS RESTRICTIVE ALTERNATIVE
BEFORE A CONTENT-BASED RESTRICTION OF PROTECTED SPEECH
CAN SURVIVE STRICT SCRUTINY

CONSTITUTIONAL LAW—ESTABLISHMENT CLAUSE—A POLICY ALLOWING POTENTIAL RELIGIOUS
EXPRESSION AT GOVERNMENT-SPONSORED EVENTS VIOLATES THE ESTABLISHMENT
CLAUSE IF THE GOVERNMENT ENTITY CREATED THE POLICY WITH THE
PURPOSE TO PROMOTE RELIGIOUS BELIEFS

RECENT DECISIONS
OF THE MISSISSIPPI SUPREME COURT AND
THE MISSISSIPPI COURT OF APPEALS



Keep your office informed with a subscription to the *Recent Decisions of the Mississippi Supreme Court and Court of Appeals*. Briefs of the Mississippi Supreme Court and Mississippi Court of Appeals are written by Journal members and mailed by Tuesday of the week after the decisions are rendered, or e-mailed by Monday of the week after the decisions are rendered, several weeks before cases are printed in the regional reporter. You can receive this weekly publication and be up to date for \$75 per year—an indispensable service! Subscribe now, or write for a free sample of the most current briefs.

Mississippi Law Journal
P.O. Box 849

University, Mississippi 38677-0849

If you are currently a subscriber by mail and wish to receive your briefs by e-mail, please e-mail our office at mslj@olemiss.edu, or pnail@olemiss.edu.

The *Mississippi Law Journal* is published three times annually during a school year (September through August). The current subscription publication schedule is September (issue 1-Fall), January (issue 2-Winter) and April (issue 3-Spring). Editorial and business offices: Post Office Box 849, University, Mississippi 38677.

Current subscription: \$35.00 per year. Single issue: \$12.00. Subscriptions are renewed automatically upon expiration unless the subscriber sends notice of termination.

Change of address: Send address changes directly to the *Mississippi Law Journal*. Include name, new address (including zip code), and old address. Please notify forty-five days in advance to ensure prompt delivery.

Unless a claim is made for nonreceipt of the *Journal* within six months after the mailing date, the *Mississippi Law Journal* cannot be held responsible for supplying those issues without charge.

Third class postage paid at University, Mississippi 38677 and additional mailing offices.

Contributors are requested to submit manuscripts in 12 point type, double-spaced in hard copy form and on a 3.5" diskette in WordPerfect 6.0, 6.1, 8 or an easily convertible format. Submissions may also be sent electronically to:

mslj@sunset.backbone.olemiss.edu

All submissions should be addressed to:

Executive Articles Editor
Mississippi Law Journal
P.O. Box 849
University, MS 38677

Citations conform to A UNIFORM SYSTEM OF CITATION (17th ed. 2000).

The *Mississippi Law Journal* is a member of the National Conference of Law Reviews.

To offer its contributors complete freedom, the *Journal* assumes no responsibility for the views expressed herein.

Robert C. Khayat Scholarship Endowment

The *Mississippi Law Journal* established the endowment in February of 1995 to honor the dedicated service of Robert C. Khayat, former Law Journal member, professor, and now University Chancellor, and to assist distinguished men and women of the *Journal* in the pursuit of their legal education at the University of Mississippi. As of December 31, 1998, the corpus of the endowment was \$39,302.58. Each year deserving *Journal* members are awarded scholarships as selected by the Executive Board of the *Journal*. Last year \$1,500 was awarded to Journal members. Please help us increase the corpus of the endowment so that we can increase the number and size of these scholarships.

Checks should be made payable to and mailed to:

The University of Mississippi Foundation
Post Office Box 8288
University, MS 38677

Please note on your check that your gift is designated for the Robert C. Khayat Scholarship Endowment.

Contributions are tax deductible.

The Law Firm of
MITCHELL, McNUTT, THREADGILL, SMITH & SAMS, P.A.

is pleased to announce that
H. Richmond Culp III
has returned to practice law with the firm as a shareholder
and that

Kate Margolis, Trey Bourn and Zachary Scruggs
have joined the firm in the Jackson office
and that

S. Ray Hill III
has joined the firm in the Oxford office
and that

Melissa A. Harrison
has joined the firm in the Tupelo office
effective September 2000

Guy Mitchell, Sr. (1881-1969)
Guy Mitchell, Jr. (1912-1986)

L.F. Sams, Jr.
Taylor B. Smith
Guy W. Mitchell, III
William C. Spencer
David L. Sanders
James L. Carroll
Claude F. Clayton, Jr.
Wendell H. Trapp, Jr.
William C. Murphree
Ronald L. Roberts
Albert G. Delgadillo
John S. Hill
Michael D. Ferris
Richard H. Spann
W. Scott Collins
James Arden Barnett, Jr.
Timothy W. Lindsay
* Also admitted in Tennessee

Otis R. Tims
Donna M. Barnes
H. Richmond Culp III
Michael D. Chase
Jim Warren
Martha Bost Stegall
John G. Wheeler
Tacey Clark Clayton
D. Andrew Phillips
Gregg A. Caraway
Myles A. Parker
D. Bradley Walsh*
Jeffrey J. Turnage
Berkley N. Huskison
William G. Armistead
L. Bradley Dillard, Sr.*
Don L. Fruge', Jr.
William C. Spencer, Jr.
William H. Davis, Jr.
James P. Wilson, Jr.* **
** Also admitted in Alabama

David K. Pharr
Bradley R. Peacock
J. Chadwick Mask
David A. Prather*
Holly S. Mathews **
David W. Shelton
Terrence L. High
Kate Margolis
Trey Bourn
Melissa A. Harrison
S. Ray Hill III
Zachary Scruggs
COUNSEL
Sonja A. Jenkins
Elizabeth Jane Hicks***
OF COUNSEL
R. N. McNutt
William J. Threadgill
Wade H. Lagrone
W. H. Jolly Jr.
*** Also admitted in New York

105 SOUTH FRONT STREET
POST OFFICE BOX 7120
TUPELO, MISSISSIPPI 38802
(662) 842-3871

SKYTEL CENTER, SUITE 900 NORTH
POST OFFICE BOX 1005
JACKSON, MISSISSIPPI 39215-1005
(601) 948-8508

215 FIFTH STREET NORTH
POST OFFICE BOX 1366
COLUMBUS, MISSISSIPPI 39703
(662) 328-2316

1255 LYNNFIELD ROAD
BUILDING A, SUITE 123
MEMPHIS, TENNESSEE 38119
(901) 767-5185

508 WALDRON STREET
POST OFFICE BOX 1200
CORINTH, MISSISSIPPI 38835
(662) 286-9931

1216 VAN BUREN
POST OFFICE BOX 947
OXFORD, MISSISSIPPI 38665
(662) 234-4845

Administrative Officers of the University of Mississippi

ROBERT C. KHAYAT	<i>Chancellor</i>
CAROLYN ELLIS STATON	<i>Provost and Vice Chancellor for Academic Affairs</i>
GLORIA KELLUM	<i>Vice Chancellor for University Affairs</i>
JOHNNY WILLIAMS	<i>Vice Chancellor for Administration and Finance</i>
MORRIS STOCKS	<i>Interim Associate Provost</i>
THOMAS WALLACE	<i>Interim Vice Chancellor for Student Life</i>
ANDREW P. MULLINS, JR.	<i>Executive Assistant to the Chancellor</i>
SAMUEL M. DAVIS	<i>Dean of the School of Law; Holder of the Jamie L. Whitten Chair of Law and Government and Professor of Law</i>
MAURICE EFTINK	<i>Associate Provost and Interim Dean of the Graduate School</i>

THE LAW SCHOOL FACULTY

GUTHRIE T. ABBOTT, <i>Butler, Snow, O'Mara, Stevens and Cannada</i>
<i>Lecturer in Law and Professor of Law</i>
WENDY ABBOTT, <i>Visiting Assistant Professor of Law</i>
DONNA D. ADLER, <i>Associate Professor of Law</i>
RICHARD L. BARNES, <i>Leonard B. Melvin, Jr. Lecturer in Law and</i>
<i>Professor of Law</i>
DEBORAH H. BELL, <i>Professor of Law</i>
CHARLES BROWER, II, <i>Croft Assistant Professor of International Law</i>
JOHN R. BRADLEY, <i>Professor of Law</i>
LARRY S. BUSH, <i>Professor of Law and Director of the Cambridge</i>
<i>Summer Session</i>
WILLIAM M. CHAMPION, <i>Professor Emeritus and Mississippi</i>
<i>Defense Lawyers Association Distinguished Lecturer Emeritus</i>
GEORGE C. COCHRAN, <i>Professor of Law</i>
AARON S. CONDON, <i>Professor Emeritus of Law</i>
JOHN CZARNETZKY, <i>Associate Professor of Law</i>
ROBERT N. DAVIS, <i>Professor of Law</i>
JASON DERRICK, <i>Temporary Legal Writing Specialist and Temporary</i>
<i>Acting Assistant Professor of Law</i>
THOMAS R. ETHRIDGE, <i>Professor Emeritus of Law</i>
D. MICHAEL FEATHERSTONE, <i>Professor of Law</i>
DON L. FRUGE, <i>President-CEO of the University of Mississippi</i>
<i>Foundation and Professor Emeritus of Law</i>
KRIS GILLILAND, <i>Director of Law Library and Assistant Professor of Law</i>

MICHAEL GORDON, *Assistant Professor of Law and Director, Clinical Programs*
 STEPHEN GOROVE, *Professor Emeritus of Law*
 KAREN O. GREEN, *Professor of Law*
 PATRICIA KRUEGER, *Temporary Legal Writing Specialist and Acting Temporary Acting Assistant Professor*
 TIMOTHY L. HALL, *Professor of Law*
 MICHAEL H. HOFFHEIMER, *Mississippi Defense Lawyers Association Distinguished Lecturer and Professor of Law*
 KIMBERLY JONES, *Temporary Acting Assistant Director of Legal Writing, Director of Academic Excellence Program, and Acting Assistant Professor of Law,*
 ROBERT C. KHAYAT, *Chancellor and Professor of Law*
 THOMAS R. MASON, *Director of Public Service Internship and Professor of Law*
 RICHARD MCLAUGHLIN, *Associate Professor of Law and Director of the Hawaii Summer Session*
 ROBERT MINK, *Acting Director of Legal Writing and Acting Assistant Professor of Law*
 STEWART MORITZ, *Visiting Assistant Professor of Law*
 GARY MYERS, *Professor of Law*
 JACK NOWLIN, *Assistant Professor of Law*
 LARRY J. PITTMAN, *Associate Professor of Law*
 RONALD J. RYCHLAK, *Associate Dean for Academic Affairs and Professor of Law*
 CAROLYN ELLIS STATON, *Provost, Vice Chancellor for Academic Affairs and Professor of Law*
 BRYN R. VAALER, *Professor of Law*
 ROBERT A. WEEMS, *Mississippi Defense Lawyers Association Distinguished Lecturer and Professor of Law*

ADJUNCT PROFESSORS

J. HALE FREELAND, *Adjunct Professor of Law*
 JOHN HAILMAN, *Adjunct Professor of Law*
 POPE MALLETTE, *Adjunct Profess of Law*
 DAVID O'DONNELL, *Adjunct Profess of Law*
 MARJORIE O'DONNELL, *Adjunct Professor of Law*
 J. CAL MAYO, JR., *Adjunct Professor of Law*
 EUGENE HOLMES, *Adjunct Professor of Law*
 CHARLES PAZAR, *Adjunct Professor of Law*



Digitized by the Internet Archive
in 2012 with funding from
LYRASIS Members and Sloan Foundation

<http://archive.org/details/mississippilawjo70samu>

MISSISSIPPI LAW JOURNAL

PUBLISHED BY STUDENTS AT THE
UNIVERSITY OF MISSISSIPPI SCHOOL
OF LAW

VOLUME 70

FALL 2000

NUMBER 1

COPYRIGHT © 2000 MISSISSIPPI LAW JOURNAL, INC.

Editor-in-Chief
JULIE M. JARRELL

Executive Editor
RACHEL M. PIERCE

Executive Articles Editors
ERIN ARGO
CLAY RICHARDS

Business Manager
CHRIS SHAW

Notes & Comments Editor
JASON BUSH

Mississippi Cases
RON WOODRUFF

ASSOCIATE EDITORS

Articles
LAWRENCE COCO
DAVID GOODMAN
CHRIS GRAHAM
MARC HARROLD
STEWART LEE
ALEXANDRA MARKOV
AMY RICHARDS

Notes & Comments
JOHN HINKLE
FREDERICK SALVO

Mississippi Cases
PAYNE ATKINSON
MOLLY FERGUSON
PATRICIA FLEMING
JAMES HALL
TREY WATKINS

Index & Review
EMILY HOGUE

Developmental & Web Editor
LILLOUS ANN SHOEMAKER

Administrative Assistant
PEGGY C. NAIL

Faculty Advisors
GUTHRIE T. ABBOTT
DEBORAH H. BELL
ROBERT WEEMS

STAFF

DANNY ANDERSEN
KELLI CARTER
CHAD DAVIDSON
BRYAN DYE
JOHN ELSTAD
JESS FREY
KATHLEEN M. FITZGERALD
HOUSTON GRAVES
KAREN GRIFFIN
KEVIN HAMILTON
CHARLES HEWINS
BRIAN HOLOFCHAK
ROBERT IRELAND
BRIAN KIMBALL

KRISI ALLEN LEE
ANDY LOWRY
HOLLIE MATHIS
THOMAS MCKNIGHT
JUDSON MCMILLIN
MOLLY MITCHELL
JEFF MOFFETT
JAY NORRIS
TROY ODOM
HEATHER PRESTON
ROBERT WALKER
JASON WATKINS
JEFFREY M. WILLIAMS
GRETCHEN WINSTEAD

Mississippi Law Journal

Published by Students at the
University of Mississippi School
of Law

VOLUME 70

FALL 2000

NUMBER 1

Copyright © 2000 Mississippi Law Journal, Inc.

ARTICLES

THE CRIMINALIZATION OF JUVENILE JUSTICE: LEGISLATIVE RE-
SPONSES TO "THE PHANTOM MENACE" *Samuel Marion Davis* 1

CHANGE OF CONTROL BOARD: FEDERAL PREEMPTION OF THE LAW
GOVERNING A TARGET'S DIRECTORS . . . *Samuel C. Thompson, Jr.* 35

THINKING OUT LOUD ABOUT THE MYTH OF *ERIE*: PLUS A GOOD
WORD FOR SECTION 1652 *Jerome A. Hoffman* 163

ADVERTISEMENTS AND SPONSORSHIPS IN CHARITABLE
CYBERSPACE: VIRTUAL REALITY MEETS LEGAL FICTION
. *Darryll K. Jones* 323

COMMENTS

PROPOSALS FOR A FEDERAL PROHIBITION OF INTERNET
GAMBLING: ARE THERE ANY OTHER VIABLE SOLUTIONS TO
THIS PERPLEXING PROBLEM? *David Goodman* 375

SELECTIVE DISCLOSURE: "A FENCING MATCH CONDUCTED
ON A TIGHTROPE" AND REGULATION FD—THE SEC'S LATEST
ATTEMPT TO "ELECTRIFY THE TIGHTROPE" *Clay Richards* 417

RECENT DECISIONS

CONSTITUTIONAL LAW—FIRST AMENDMENT—APPLICATION OF
PUBLIC ACCOMMODATIONS LAW VIOLATES FIRST AMENDMENT
WHEN ORGANIZATION'S EXPRESSIVE ACTIVITY IS SIGNIFICANTLY
BURDENED *Kelly Carter* 441

CONSTITUTIONAL LAW—FIRST AMENDMENT—GOVERNMENT MUST
DEMONSTRATE THAT THERE IS NOT A LESS RESTRICTIVE
ALTERNATIVE BEFORE A CONTENT-BASED RESTRICTION OF
PROTECTED SPEECH CAN SURVIVE STRICT
SCRUTINY *Chad Davidson* 457

CONSTITUTIONAL LAW—ESTABLISHMENT CLAUSE—A
POLICY ALLOWING POTENTIAL RELIGIOUS EXPRESSION AT
GOVERNMENT-SPONSORED EVENTS VIOLATES THE ESTABLISHMENT
CLAUSE IF THE GOVERNMENT ENTITY CREATED THE POLICY WITH
THE PURPOSE TO PROMOTE RELIGIOUS BELIEFS . *Brian Kimball* 473

THE CRIMINALIZATION OF JUVENILE JUSTICE: LEGISLATIVE RESPONSES TO "THE PHANTOM MENACE"

*Samuel Marion Davis**

I. INTRODUCTION

For the last decade in particular, a trend has been developing toward more punitive treatment of juveniles, both in terms of the numbers of juveniles that are being prosecuted as adults as well as the sentencing or dispositional options that are available in such cases. The trend has been chronicled in the popular press¹ as well as in the scholarly literature.² Indeed, because so many juveniles are being prosecuted as adults, and because the process for those who remain in juvenile court has been "criminalized" to the point that little remains to distinguish it from criminal court, many commentators have called for its abolition.³ This article will examine

* Dean, Professor of Law, and Holder of the Jamie L. Whitten Chair of Law and Government, University of Mississippi School of Law; B.A., University of Southern Mississippi; J.D., University of Mississippi School of Law; LL.M., University of Virginia School of Law.

¹ Kristen Choo, *Minor Hardships*, 86 A.B.A. J. 20 (Sept. 2000).

² See, e.g., FRANKLIN E. ZIMRING, *AMERICAN YOUTH VIOLENCE* (1998) [hereinafter cited as ZIMRING]; Jan A. Wheeler, et al., *Once We Know Who, What, and Where, Will We Ask Why?: Demographics and Dispositions of Children Processed in the Adult Criminal Justice System in Georgia*, 18 QUINNIPIAC L. REV. 597 (1999); Claude Noriega, Note, *Stick a Fork in It: Is Juvenile Justice Done?*, 16 N.Y. L. SCH. J. HUM. RTS. 669 (2000).

³ See, e.g., Janet E. Ainsworth, *Re-Imagining Childhood and Reconstructing the Legal Order: The Case for Abolishing the Juvenile Court*, 69 N.C. L. REV. 1083 (1991); Katherine Hunt Federle, *The Abolition of the Juvenile Court: A Proposal for the Preservation of Children's Legal Rights*, 16 J. CONTEMP. L. 23 (1990); Barry C. Feld, *Juvenile Court Legislative Reform and the Serious Young Offender: Dismantling the "Rehabilitative Ideal,"* 65 MINN. L. REV. 167 (1980); F. Barry McCarthy, *Delinquency Dispositions Under the Juvenile Justice Standards: The*

the nature of the trend toward increased adult treatment of juveniles and its underlying assumptions and will propose some safeguards against potential abuse of the prosecutorial function.

Over the last twenty years virtually every state has enacted laws designed to address what is perceived as a worsening juvenile crime problem. New York, for example, was one of the first states to allow criminal prosecution of juveniles at an early age. In New York sixteen is the jurisdictional age for delinquent minors in family court.⁴ Thus, all youths sixteen or older go to criminal court, and in some cases youths as young as thirteen, if charged with one of certain enumerated offenses, can be prosecuted as adults.⁵ Indeed, their cases

Consequences of a Change of Rationale, 52 N.Y.U. L. REV. 1093 (1977); Lucia Beadel Whisenand & Edward J. McLaughlin, *Completing the Cycle: Reality and the Juvenile Justice System in New York State*, 47 ALB. L. REV. 1 (1982) [hereinafter cited as Whisenand & McLaughlin]. Others, however, have disagreed and have called for reform of the present court and the juvenile justice system rather than abolition. See, e.g., Hon. Irving R. Kaufman, *The Child in Trouble: The Long and Difficult Road to Reforming the Crazy-Quilt Juvenile Justice System*, 60 WASH. U. L.Q. 743 (1982); Irene Merker Rosenberg, *Leaving Bad Enough Alone: A Response to the Juvenile Court Abolitionists*, 1993 WIS. L. REV. 163; see also Ira M. Schwartz et al., *Nine Lives and Then Some: Why the Juvenile Court Does Not Roll Over and Die*, 33 WAKE FOREST L. REV. 533 (1998).

⁴ N.Y. FAM. CT. ACT § 301.2(1) (McKinney Supp. 2001). The jurisdictional age for persons in need of supervision is 16 for males and 18 for females. *Id.* § 712(a). However, this provision was held unconstitutional on equal protection grounds in *Patricia A. v. City of New York*, 286 N.E.2d 432 (N.Y. 1972). North Carolina also uses 16 as the jurisdictional age for minors alleged to be delinquent or undisciplined, N.C. GEN. STAT. § 7B-1501(7), (27) (1999) (except where the undisciplined allegation is that the minor is beyond parental control, is regularly found in places where minors may not lawfully be present, or has run away from home, in which case the jurisdictional age is 18), and 18 as the jurisdictional age for minors alleged to be abused, dependent, or neglected. N.C. GEN. STAT. § 7B-101(1), (9), (14), (15).

⁵ N.Y. FAM. CT. ACT § 301.2(8); N.Y. PENAL LAW §§ 10(18), 30 (McKinney Supp. 2001); N.Y. CRIM. PROC. LAW §§ 180.75, 190.71, 210.43, 220.10(5)(g) (McKinney 1993 & Supp. 2001). The enumerated offenses include, for minors 13 or older, second-degree murder, and for minors 14 or older, second-degree murder, felony murder, first-degree kidnapping, first- or second-degree arson, first-degree assault, first-degree manslaughter, first-degree rape, first-degree sodomy, aggravated sexual abuse, first- or second-degree burglary, first- or second-degree robbery, certain firearms offenses, attempted murder, and attempted first-degree kidnap-

originate in criminal court, where the court has discretion to transfer appropriate cases to family court for handling as juvenile matters.⁶

In contrast, in most states the jurisdictional age of the juvenile court is eighteen,⁷ although in a few states the jurisdictional age is seventeen.⁸ Even in these states, however, there are procedural mechanisms that allow younger youths to be prosecuted as adults. These methods include: (1) transfer by the juvenile court; (2) transfer (or as it is more commonly known, reverse certification) by the criminal court; (3) concurrent jurisdiction by juvenile and criminal courts; (4) prosecutorial discretion; and (5) exclusion of certain offenses from the juvenile court's jurisdiction. Most jurisdictions do not employ any one of these methods exclusively. Rather, one commonly finds that one or more methods are employed within the same jurisdiction. The procedural mechanisms will be discussed in turn.

II. METHODS BY WHICH JUVENILES ARE PROSECUTED AS ADULTS

A. *Waiver and Transfer by the Juvenile Court*

The most common method by which a juvenile can be prosecuted as an adult is through waiver of jurisdiction by the juvenile court and transfer to adult court for criminal prosecu-

ping. One may find it strange that first-degree murder is not an enumerated offense. The reason for its omission is that an element of first-degree murder in New York is that the accused is at least 18 years of age. N.Y. PENAL LAW § 125.27(1)(b) (McKinney 1998).

⁶ *Id.* New York employs this means, often called "reverse certification," as the exclusive means by which jurisdiction is allocated between juvenile and criminal courts. Reverse certification, as well as other methods of allocating jurisdiction, is discussed below.

⁷ More than two-thirds of the states as well as the District of Columbia use 18 as the jurisdictional age of the juvenile court. *See, e.g.,* ALASKA STAT. § 47-10-010(a) (Michie 1998); CAL. WELF. & INST. CODE §§ 601, 602 (West Supp. 2001); MINN. STAT. ANN. § 260B.007(3) (West Supp. 2001); VA. CODE ANN. § 16.1-228 (Michie 1999).

⁸ *See, e.g.,* MO. ANN. STAT. § 211.021(2) (West 1996); TEX. FAM. CODE ANN. § 51.02(2) (West 1996).

tion. All but four states⁹ employ judicial waiver by the juvenile court either exclusively or in conjunction with other methods. These four states generally use some other method as the predominant or exclusive means for allocating jurisdiction between courts. For example, in New York the absence of waiver by the family court is explained by virtue of the fact that, as mentioned above,¹⁰ the jurisdictional age for delinquent minors is set very low, at sixteen, the lowest jurisdictional age recognized in the country. Since the jurisdictional age is low, waiver by the family court is not regarded as a plausible alternative. Moreover, as previously mentioned,¹¹ in New York "reverse certification," wherein certain cases originate in the criminal court, which has discretion to transfer appropriate cases to the family court, is the exclusive means by which jurisdiction is allocated between family and criminal courts.

Similarly, in Nebraska the absence of a waiver option by the juvenile court is explainable because another method is employed as the means for allocating jurisdiction between courts. In Nebraska the juvenile and criminal courts have concurrent jurisdiction over the more serious offenses, and the prosecutor makes the decision whether to file the case in criminal court or juvenile court.¹²

Massachusetts discontinued the waiver option as a result of legislation enacted in 1996.¹³ The former waiver statute¹⁴ was repealed¹⁵ and the existing statutes were amended to create an alternative means for dealing with older serious

⁹ The four states are Massachusetts, Nebraska, New Mexico, and New York.

¹⁰ See *supra* note 4 and accompanying text.

¹¹ See *supra* notes 5-6 and accompanying text.

¹² NEB. REV. STAT. §§ 43-247, 43-276 (1998). In addition, a minor may seek transfer from criminal court to juvenile court. *Id.* § 43-261. Nebraska is the only state that employs concurrent jurisdiction as the exclusive means for allocating jurisdiction between juvenile and criminal courts, although several states use concurrent jurisdiction in addition to waiver by the juvenile court as a means of allocating jurisdiction. See statutes cited *infra* notes 39-43.

¹³ 1996 Mass. Acts ch. 200, §§ 1 *et seq.*

¹⁴ Former MASS. GEN. LAWS ANN. ch. 119, § 61 (repealed 1996).

¹⁵ 1996 Mass. Acts ch. 200, § 7.

offenders. The amending legislation created a new category—youthful offender—that includes minors who are alleged to have committed a felony at age fourteen or older and who either have been committed previously as a minor, or have committed an offense involving infliction or threat of serious bodily harm, or have committed one of certain firearms offenses.¹⁶ The prosecutor has discretion to proceed against a youthful offender by complaint or indictment, and while the youthful offender is handled in juvenile court or a juvenile session of the district court, the youthful offender designation subjects the minor to either a juvenile disposition or any sentence that can be imposed against an adult convicted of the same offense in criminal court.¹⁷

New Mexico also has discontinued the waiver option, as a result of legislation enacted in 1993.¹⁸ As in the case of Massachusetts, the absence of the waiver option is explained by the alternative method created under the new code for treatment of older serious offenders. Under the new Children's Code, minors fifteen or older who are indicted or bound over for trial on a charge of first-degree murder—designated serious youthful offenders—are excluded from the juvenile court's jurisdiction.¹⁹ In addition, a new category—youthful offenders—was created that includes several classes of older minors who are charged with serious offenses or who have prior records.²⁰ In the case of a minor adjudicated a youthful offend-

¹⁶ MASS. GEN. LAWS ANN. ch. 119, § 52 (West Supp. 2000).

¹⁷ *Id.* §§ 52, 54, 55A, 58.

¹⁸ The 1993 legislation repealed the former CHILDREN'S CODE, 1993 N.M. LAWS ch. 77, § 234, and simultaneously created the new CHILDREN'S CODE effective July 1, 1993. *Id.* §§ 10-227.

¹⁹ N.M. STAT. ANN. § 32A-2-3(H) (Michie Supp. 1999). See *infra* notes 61-64 and accompanying text for a discussion of exclusion of offenses as a means of allocating jurisdiction between juvenile and criminal courts.

²⁰ The youthful offender category includes (1) minors 14 or older adjudicated delinquent for second-degree murder, assault with intent to commit a violent felony, kidnapping, aggravated battery, aggravated battery upon a police officer, shooting at a dwelling or occupied building or shooting at or from a motor vehicle, dangerous use of explosives, criminal sexual penetration, robbery, aggravated burglary, aggravated arson, or abuse of a child that results in great bodily harm or death to the child; (2) minors 14 or older adjudicated for any felony who have

er, the prosecutor is authorized, following notice, to seek an adult sentence in lieu of a juvenile disposition.²¹

Two additional states²² provide for waiver but in a non-traditional form. Arkansas, in addition to providing for traditional waiver and transfer by the juvenile court,²³ also provides for allocation of jurisdiction between courts through exercise of prosecutorial rather than judicial discretion. The juvenile and criminal courts have concurrent jurisdiction in two categories of cases—those involving minors sixteen or older charged with a felony and those involving minors fourteen or older charged with one of certain enumerated serious offenses—and the prosecutor has discretion to file a charge in either court.²⁴ Once a charge is filed either court may waive its jurisdiction and transfer the case to the other court following a hearing.²⁵

Montana also provides for a nontraditional form of waiver and transfer. In Montana the decision on allocation of jurisdiction is shared by the prosecutor and the district court, the court vested with general criminal jurisdiction. The prosecutor has discretion to file a motion in district court seeking approval to file certain cases directly in district court, namely those involving a minor twelve or older charged with one of certain enumerated serious offenses.²⁶ The district court must grant

three prior felony adjudications within a three-year period immediately preceding the current offense; and (3) minors 14 or older adjudicated delinquent for first-degree murder. *Id.* § 32A-2-3(I).

²¹ *Id.* § 32A-2-20.

²² Arkansas and Montana.

²³ ARK. CODE ANN. § 9-27-318(b) (Michie Supp. 1999).

²⁴ *Id.* § 9-27-318(c). The prosecutor may not directly file a charge based on a nonenumerated offense in criminal court, even though it arises out of the same conduct resulting in a charge on an enumerated offense. In such a case the prosecutor's only recourse is to file the nonenumerated offense in juvenile court and to seek transfer to criminal court. *Id.* § 9-27-318(d); see *Rice v. State*, 954 S.W.2d 216 (Ark. 1997).

²⁵ ARK. CODE ANN. § 9-27-318(d)-(i) (Michie Supp. 1999).

²⁶ MONT. CODE ANN. § 41-5-206(1) (1999). In addition, the statute provides that the prosecutor *shall* file a motion seeking permission to file an information directly in district court in the case of a minor 17 or older accused of an enumerated offense. *Id.* § 41-5-206(2) (emphasis added).

the prosecutor's motion to file an information if it finds probable cause to believe the minor committed the offense charged. Once the information is filed, the court must hold a hearing within thirty days, unless it is waived by the minor, to determine whether the case should be transferred to juvenile court or handled in district court. The court's decision is based on consideration of the need for community protection, the best interests of the minor, and the seriousness of the offense.²⁷

Clearly, the states that do not provide for judicial waiver by the juvenile court choose not to do so because they prefer an alternative means for deciding which minors should be prosecuted as adults. The vast majority of states, however, provide for waiver by the juvenile court either as the sole means by which jurisdiction is allocated between courts or in conjunction with some other means. In these states, the underlying presumption, of course, is that most cases will be retained in juvenile court and treated as juvenile matters and only the exceptional cases, typically involving older youths charged with serious offenses, will be transferred, or certified, for criminal prosecution.

States authorize waiver and transfer under a variety of circumstances. Some states allow waiver in the case of any juvenile, regardless of age and regardless of the offense charged.²⁸ Others specify an age requirement but no offense requirement, thus allowing waiver in the case of any juvenile over a certain age, regardless of the seriousness of the offense.²⁹ Still others specify an offense requirement but no age requirement, allowing transfer of any juvenile charged with an enumerated offense regardless of age.³⁰ The most prevalent

²⁷ *Id.* § 41-5-206(3). The hearing requirement was added following the Montana Supreme Court's decision in *State v. Butler*, 977 P.2d 1000 (Mont. 1999), in which the court held that a hearing on the question of whether the case should be handled as a juvenile or criminal matter is required by due process of law.

²⁸ ALASKA STAT. § 47.12.100 (Michie 1998); ARIZ. JUV. CT. R. PROC. 14; KAN. STAT. ANN. § 38-1636(a)(1)-(2) (Supp. 1999); WASH. REV. CODE ANN. § 13.40.110(1) (West Supp. 1999); WYO. STAT. ANN. § 14-6-237(a) (Michie 1999).

²⁹ ALA. CODE § 12-15-34(a) (Supp. 2000); CAL. WELF. & INST. CODE § 707 (West Supp. 2001); FLA. STAT. ANN. § 985.226(1)-(2) (West Supp. 2001); MISS. CODE ANN. § 43-21-157(1) (Supp. 2000).

³⁰ ME. REV. STAT. ANN. tit. 15, § 3101(4)(A), (E) (West 1980 & Supp. 2000);

model specifies both age and offense requirements, permitting waiver and transfer with respect to any juvenile over a certain age charged with an enumerated offense or an offense falling within a particular category (e.g., a felony or a Class A felony).³¹ Finally, several states allow waiver and transfer based on some combination of the above circumstances.³²

B. Waiver and Transfer by the Criminal Court (Reverse Certification)

A second method by which a juvenile may be treated as an adult is commonly called reverse certification. With this method, certain cases—again, typically those involving older youths charged with serious offenses—originate in criminal court. The criminal court then has discretion to retain jurisdiction over the case or to waive its jurisdiction and transfer the case to juvenile court for handling as a juvenile case. About a

N.H. REV. STAT. ANN. § 169-B:24(I), (IV) (Supp. 2000); OKLA. STAT. ANN. tit. 10, § 7303-4.3(B) (West 1998); S.D. CODIFIED LAWS § 26-11-4 (Michie 1999).

³¹ ARK. CODE ANN. § 9-27-318(b) (Michie Supp. 1999); COLO. REV. STAT. § 19-2-518(1) (1999); CONN. GEN. STAT. ANN. § 46b-127 (West Supp. 2000); LA. CHILDREN'S CODE ANN. art. 857 (West Supp. 2000); MICH. COMP. LAWS ANN. § 712A.4(1) (West Supp. 2000); MINN. STAT. ANN. § 260B.125(1), (3), (5) (West Supp. 2001); MO. ANN. STAT. § 211.071(1) (West Supp. 2001); NEV. REV. STAT. ANN. § 62.080 (Michie 1996); N.J. STAT. ANN. §§ 2A:4A-26 (West Supp. 2000), 2A:4A-27 (West 1987); N.C. GEN. STAT. § 7B-2200 (1999); OHIO REV. CODE ANN. § 2151/26(B)-(C) (Anderson 1998); OR. REV. STAT. §§ 419C.349, 419C.352 (Supp. 1999); TEX. FAM. CODE ANN. § 54.02(a)(1)-(2), (j) (West Supp. 2001); VT. STAT. ANN. tit. 33, § 5506(a) (1991 & Supp. 1999); VA. CODE ANN. §§ 16.1-269.1(A)-(B), (D), 16.1-270 (Michie 1999).

³² DEL. CODE ANN. tit. 10, § 1010(a), (e) (Supp. 1999); D.C. CODE ANN. § 16-2307(a), (e-2) (Supp. 2000); GA. CODE ANN. §§ 15-11-30.2(a)(4), (b)(3)-(4), 15-11-30.3 (Supp. 2000); HAW. REV. STAT. § 571-22(a)-(b), (d)-(e) (Supp. 1999); IDAHO CODE § 20-508(1) (Supp. 2000); 705 ILL. COMP. STAT. ANN. 405/5-805(1)-(3) (West 2000); IND. CODE ANN. §§ 31-30-3-2 to -6 (Michie 1997); IOWA CODE ANN. § 232.45(6)-(7) (West Supp. 2000); KY. REV. STAT. ANN. §§ 635.020(2)-(7), 640.010 (Michie Supp. 2000); MD. CODE ANN., CTS. & JUD. PROC. § 3-817(a) (Supp. 1999); N.D. CENT. CODE § 27-20-34(1) (Supp. 1999); 42 PA. CONS. STAT. ANN. § 6355(a)(1), (a)(4)(ii), (e) (West 2000); R.I. GEN. LAWS §§ 14-1-7, 14-1-7.1, 14-1-7.2 (1994 & Supp. 1999); S.C. CODE ANN. § 20-7-7605(4)-(6), (9)-(10) (Law Co-op Supp. 2000); TENN. CODE ANN. § 37-1-134(a)(1) (Supp. 2000); UTAH CODE ANN. §§ 78-3a-602, 78-3a-603 (1996 & Supp. 2000); W. VA. CODE § 49-5-10(c)-(g) (1999); WIS. STAT. ANN. § 938.18(1)(a) (West Supp. 2000).

dozen states³³ employ this method.

In New York, for example, cases involving minors thirteen or older charged with second-degree murder, as well as minors fourteen or older (but less than sixteen) charged with one of certain enumerated offenses originate in criminal court, which has discretion to transfer appropriate cases to family court.³⁴ In fact, in New York any such case must originate in criminal court; the only means by which a family court can exercise jurisdiction in such a case is on transfer from criminal court.³⁵ The other states have similar provisions.³⁶ The reverse certification statutes have been challenged on due process and equal protection grounds, but they have been upheld by the courts.³⁷

Reverse certification, as with transfer by the juvenile court, involves an exercise of judicial discretion, but a major difference between the two is that with reverse certification the legislature has determined categorically that some juveniles should be prosecuted as adults. The underlying pre-

³³ Connecticut, Georgia, Iowa, Mississippi, New York, Oklahoma, Pennsylvania, South Carolina, South Dakota, Vermont, and Wisconsin.

³⁴ N.Y. FAM. CT. ACT § 301.2(8) (McKinney Supp. 2001); N.Y. PENAL LAW §§ 10(18), 30 (McKinney Supp. 2001); N.Y. CRIM. PROC. LAW §§ 180.75, 190.71, 210.43, 220.10(5)(g) (McKinney 1993 & Supp. 2001). For a list of the enumerated offenses, see *supra* note 5.

³⁵ *In re Raymond G.*, 715 N.E.2d 486, 482 (N.Y. 1999).

³⁶ See GA. CODE ANN. § 15-11-28(b)(2) (Supp. 2000); IOWA CODE ANN. § 232.8(1)(c) (West Supp. 2000); MD. CODE ANN., CTS. & JUD. PROC. § 3-804(e)(1), (4) (1998); MD. ANN. CODE art. 27, § 594A (Supp. 2000); MISS. CODE ANN. §§ 43-21-105(j), 43-21-159(4), (7) (Supp. 2000); OKLA. STAT. ANN. tit. 10, § 7306-2.5 (West 1998); S.C. CODE ANN. § 20-7-6605 (1) (Law. Co-op Supp. 2000); S.D. CODIFIED LAWS § 26-11-3.1 (Michie 1999); VT. STAT. ANN. tit. 33, §§ 5505(b), 5516(c) (1991); WIS. STAT. ANN. § 938.183(1), (1m) (West Supp. 2000); see also CONN. GEN. STAT. ANN. § 46b-127 (West Supp. 2000).

³⁷ See, e.g., *Vega v. Bell*, 393 N.E.2d 450 (N.Y. 1979); *State ex rel. Coats v. Rakestraw*, 610 P.2d 256 (Okla. Crim. App. 1980); *Commonwealth v. Wade*, 402 A.2d 1360 (Pa. 1979); *State v. Martin*, 530 N.W.2d 420 (Wis. Ct. App. 1995); see also *State v. Angel C.*, 715 A.2d 652 (Conn. 1998). The Oklahoma statutory scheme was criticized in the aftermath of the *Rakestraw* decision. Tom R. Cornish, *Where Have All the Children Gone?—Reverse Certification*, 35 OKLA. L. REV. 373 (1982) [hereinafter cited as Cornish]. Despite such criticism, however, *Rakestraw* was reaffirmed more recently in *Douma v. State*, 749 P.2d 1163 (Okla. Crim. App. 1988).

sumption is reversed, i.e., the presumption here is that the criminal court will retain jurisdiction over most cases, and only the exceptional cases, typically involving younger youths or first-time offenders, will be transferred, or certified, to juvenile court.³⁸

C. Concurrent Jurisdiction

Some states grant concurrent jurisdiction both to the criminal court and the juvenile court in certain cases. The statutes vary, some authorizing concurrent jurisdiction over youths over a certain age regardless of offense,³⁹ some authorizing it over all youths charged with certain offenses regardless of age.⁴⁰ Most authorize concurrent jurisdiction with respect to youths over a certain age who are charged with one of enumerated serious offenses,⁴¹ and still others authorize it based on some combination of age and offense factors.⁴² Under the terms of a concurrent jurisdiction scheme, both courts have jurisdiction over certain offenses, and either court may assume jurisdiction of an eligible case. The court that first assumes jurisdiction handles the case from start to finish, or in some cases has discretion to transfer to the other court in appropriate circumstances.⁴³ About a dozen states provide for this method, either as the exclusive means by which jurisdiction is allocated between courts or in conjunction with other methods.

³⁸ See, e.g., *People v. Putland*, 102 Misc. 2d 517 (County Ct., Dutchess County 1979).

³⁹ See, e.g., WYO. STAT. ANN. §§ 14-6-203(c)-(f), 14-6-211 (Michie 1999).

⁴⁰ See, e.g., FLA. STAT. ANN. § 985.225 (West Supp. 2001); GA. CODE ANN. § 15-11-28(b) (Supp. 2000).

⁴¹ See, e.g., ARIZ. REV. STAT. ANN. § 13-501(B) (West Supp. 2000); ARK. CODE ANN. § 9-27-318(c) (Michie Supp. 1999); COLO. REV. STAT. § 19-2-517(1) (2000); D.C. CODE ANN. § 16-2301(3)(A) (1997); LA. CHILDREN'S CODE ANN. art. 305(B) (West Supp. 2000); MICH. COMP. LAWS ANN. § 712A.2(d) (West Supp. 2000); OKLA. STAT. ANN. tit. 10, § 7306-2.6(A)-(C), (E) (West Supp. 2000); S.D. CODIFIED LAWS § 26-11-3.1 (Michie 1999).

⁴² See, e.g., NEB. REV. STAT. § 43-247 (1998).

⁴³ See, e.g., ARK. CODE ANN. § 9-27-318(d)-(i) (Michie Supp. 1999); OKLA. STAT. ANN. tit. 10, § 7306-2.6(F) (West Supp. 2001).

D. Prosecutorial Discretion

Some states expressly authorize the prosecutor to decide the court—juvenile or criminal—in which a case will be handled. Typically, such statutory schemes grant the prosecutor discretion in cases involving older youths charged with the most serious offenses. In Louisiana, for example, the prosecutor has discretion, in the case of any minor fifteen or older charged with one of enumerated serious offenses, to file a petition in juvenile court or to file an information or seek an indictment in criminal court.⁴⁴ Several states expressly grant prosecutors some form of decision-making authority, usually in addition to other means of allocating jurisdiction between criminal and juvenile courts.⁴⁵

No state currently employs the prosecutorial discretion model as the exclusive method for allocating jurisdiction between courts. Wyoming formerly did so, prior to legislative changes in 1984, as a result of which Wyoming adopted a statutory scheme providing for traditional waiver and transfer by the juvenile court⁴⁶ in conjunction with a modified prosecutorial discretion/concurrent jurisdiction model.⁴⁷ Prior to the 1984 legislative changes, Wyoming's pure prosecutorial discretion model was criticized⁴⁸ in response to a case that attracted national attention at the time, that of sixteen-year-old Richard Jahnke, who was convicted of voluntary manslaughter in the shooting death of his father.⁴⁹ He raised a justification

⁴⁴ LA. CHILDREN'S CODE ANN. art. 305(B) (West Supp. 2000).

⁴⁵ See, e.g., ARK. CODE ANN. § 9-27-318(c) (Michie Supp. 1999); D.C. CODE ANN. § 16-2301(3)(A) (1997); FLA. STAT. ANN. §§ 985.225(1), 985.227(1) (West Supp. 2001); NEB. REV. STAT. § 43-276 (1998); OKLA. STAT. ANN. tit. 10, § 7306-2.6(A)-(C) (West Supp. 2001); WYO. STAT. ANN. §§ 14-6-203(c)-(f), 14-6-211 (Michie 1999); see also N.H. REV. STAT. ANN. § 169B:25 (Supp. 2000).

⁴⁶ WYO. STAT. ANN. § 14-6-237(a) (Michie 1999).

⁴⁷ *Id.* §§ 14-6-203(c)-(f), 14-6-211.

⁴⁸ See Jeffrey C. Brinkerhoff, Comment, *Prosecution as a Juvenile or Adult? Is the Discretion Vested in the District Attorney by Section 14-6-203(c) of the Wyoming Statutes Unconstitutional and Violative of the Proper Role of a Prosecutor?*, 19 LAND & WATER L. REV. 187 (1984).

⁴⁹ Richard Jahnke's conviction was affirmed on appeal. *Jahnke v. State*, 682 P.2d 991 (Wyo. 1984).

defense at trial, claiming that he had killed his father in response to a long period of persistent abuse, invoking a fear of imminent death or danger.⁵⁰ The *Jahnke* case is representative of those that create the potential for prosecutorial abuse, i.e., high profile cases that attract public attention and scrutiny, prompting a "get tough on juvenile crime" reaction from prosecutors.⁵¹

Prosecutorial discretion models have faced other challenges as well. A Utah statute⁵² authorizing the prosecutor to file charges in criminal court or to file a petition in juvenile court in cases involving minors sixteen or older accused of a capital offense or any first-degree felony was held unconstitutional under the state constitution's equal protection clause.⁵³ The court held that the statute impermissibly allowed differential treatment of juveniles without providing any criteria to guide prosecutors in their decision making.⁵⁴ The statutory scheme subsequently was rewritten to limit prosecutorial discretion and to provide statutory criteria for differentiating between classes of minors.⁵⁵

Other prosecutorial discretion statutes have fared better. In Florida the prosecutor has discretion to seek an indictment in the case of any minor charged with an offense punishable by death or life imprisonment.⁵⁶ An earlier version of this

⁵⁰ *Id.* at 994. The fact pattern is one that is sadly—and all too frequently—repeated. For another example, in which the court held that expert testimony on battered child syndrome is admissible in appropriate cases to aid in proof of self defense, see *State v. James*, 850 P.2d 495, 503 (Wash. 1993).

⁵¹ This issue is discussed *infra* notes 69, 77, 78 and accompanying text.

⁵² 1994 Utah Laws ch. 94, § 3, former UTAH CODE ANN. § 78-3a-25(6).

⁵³ *State v. Mohi*, 901 P.2d 991 (Utah 1995).

⁵⁴ *Mohi*, 901 P.2d at 1002.

⁵⁵ UTAH CODE ANN. § 78-3a-602 (1996). The new statute was upheld in *A.B. v. State*, 936 P.2d 1091 (Utah Ct. App. 1997), *cert. denied*, 945 P.2d 1118 (Utah 1997). For a more recent decision construing the new statute, see *Z.R.S. v. State*, 951 P.2d 1114 (Utah Ct. App. 1998).

⁵⁶ FLA. STAT. ANN. § 985.225(1) (West Supp. 2001). The statute provides that in the case of a minor charged with an offense punishable by death or life imprisonment, jurisdiction is vested in the criminal court *if* the minor is indicted for such offense by the grand jury. *Id.* In effect, the statute grants the prosecutor discretion to determine the court in which the case will be heard.

statute was challenged by a minor who claimed his conviction was invalid since he was tried in criminal court without the benefit of a waiver hearing in juvenile court as required by due process of law under *Kent v. United States*.⁵⁷ The Fifth Circuit denied the minor's challenge, distinguishing *Kent* on the ground that it dealt with an exercise of judicial discretion whereas the instant case involved an exercise of prosecutorial discretion, i.e., whether or not to present the case to the grand jury.⁵⁸

A separate Florida statute grants the prosecutor discretion to prosecute as adults persons who were sixteen or older at the time of the offense or who were fourteen or older and charged with one of certain enumerated offenses.⁵⁹ For similar reasons, an earlier version of this statute also was upheld against constitutional attack.⁶⁰

Prosecutorial discretion as used here refers to those states that explicitly, by statute authorize the prosecutor to determine the court in which a juvenile's case will be handled, in certain cases. In a more generic sense, however, prosecutors exercise a great deal of discretion even when other means of allocating jurisdiction are employed, such as judicial waiver by the juvenile court, judicial waiver by the criminal court, or concurrent jurisdiction. This phenomenon will be discussed below.

E. Exclusion of Certain Offenses

Many jurisdictions now simply exclude certain offenses from the juvenile court's jurisdiction. The offenses excluded might be categorical, such as all Class A felonies,⁶¹ or they

⁵⁷ 383 U.S. 541 (1966).

⁵⁸ *Woodard v. Wainwright*, 556 F.2d 781 (5th Cir. 1977); *accord*, *Russell v. Parratt*, 543 F.2d 1214 (8th Cir. 1976) (rejecting similar claim against Nebraska statute).

⁵⁹ FLA. STAT. ANN. § 985.227(1) (West Supp. 2001).

⁶⁰ *State v. Cain*, 381 So. 2d 1361 (Fla. 1980); *accord*, *Commonwealth v. Wayne W.*, 606 N.E.2d 1323 (Mass. 1993) (upholding similar Massachusetts provision).

⁶¹ *See, e.g.*, N.C. GEN. STAT. § 7B-2200 (1999).

might be listed individually in the statute itself.⁶² Some statutory schemes expressly exclude certain offenses, while others achieve the same result by requiring mandatory waiver of jurisdiction and transfer in certain kinds of cases, usually when the minor has committed a serious offense or has a prior record.⁶³ Other states provide that jurisdiction over a juvenile over whom jurisdiction has been waived previously is automatically waived in all subsequent cases involving that juvenile (the so-called "once waived, always waived" statutes).⁶⁴ More than half the states provide for some kind of mandatory exclusion. Many of these statutes have been challenged on various grounds, but for the most part they have been upheld.⁶⁵

⁶² See, e.g., ALASKA STAT. § 47.12.030(a) (Michie 1998); ARIZ. REV. STAT. ANN. § 13-501(A) (West Supp. 2000); CONN. GEN. STAT. ANN. § 46b-127(a) (West Supp. 2000); GA. CODE ANN. § 15-11-28(b) (Supp. 2000); IDAHO CODE § 20-509(1) (1997); 705 ILL. COMP. STAT. ANN. § 405/5-130(1)(a) (West 1999); IND. CODE ANN. § 31-30-1-4 (Michie 1997); LA. CHILDREN'S CODE ANN. art. 305(a) (West 1995); MINN. STAT. ANN. § 260B.125(9) (West Supp. 2001); NEV. REV. STAT. ANN. §§ 62.040(1)(b), 62.050 (Michie 1996); N.M. STAT. ANN. § 32A-2-3(H) (Michie 1999); OHIO REV. CODE ANN. § 2151.26(B)-(C) (Anderson 1998); R.I. GEN. LAWS § 14-1-3(1) (2000); UTAH CODE ANN. § 78-3a-602 (1996); WASH. REV. CODE ANN. § 13.04.030(1)(e)(v) (West 2000); WIS. STAT. ANN. § 938.183(2) (West Supp. 2000).

⁶³ See, e.g., CONN. GEN. STAT. ANN. § 46b-127 (West Supp. 2000); GA. CODE ANN. § 15-11-30.3 (Supp. 2000); HAW. REV. STAT. § 571-22 (Supp. 2000); IND. CODE ANN. § 31-30-1-4 (Michie 1997); ME. REV. STAT. ANN. tit. 15, § 3101(4)(E) (West Supp. 1999); MINN. STAT. ANN. § 260B.125(3) (West Supp. 2001); N.C. GEN. STAT. § 7B-2200 (1999); OHIO REV. STAT. ANN. § 2151.26(B) (Anderson 1998); 42 PA. CONS. STAT. ANN. § 6355(e) (West 2000).

⁶⁴ See, e.g., ALA. CODE §§ 12-15-1(8), 12-15-34(j) (Supp. 2000); CAL. WELF. & INST. CODE § 707.01(a)(5)-(6) (West 1998); FLA. STAT. ANN. § 985.226(1), (4) (West Supp. 2001); HAW. REV. STAT. § 571-22(e) (Supp. 1999); KAN. STAT. ANN. § 38-1602(b)(3)-(4) (Supp. 1999); MINN. STAT. ANN. § 260B.125(5) (West Supp. 2001); MISS. CODE ANN. § 43-21-157(8) (Supp. 2000); OHIO REV. CODE ANN. § 2151.26(B)(1) (Anderson 1998); OKLA. STAT. ANN. tit. 10, §7306-2.4(F)-(G) (West Supp. 2001); OR. REV. STAT. § 419C.364 (1995); VA. CODE § 16.1-271 (Michie 1999); WASH. REV. CODE ANN. § 13.40.020(14) (West Supp. 2000); see also MD. CODE ANN., CTS. & JUD. PROC. § 3-817(g) (1998).

⁶⁵ Statutes that exclude certain offenses outright have been upheld against various challenges, including claims that they violate due process of law, equal protection of the laws, the separation of powers doctrine, and the state supreme court's rule-making power. See, e.g., *Nao v. State*, 953 P.2d 522 (Alaska Ct. App. 1998) (separation of powers challenge); *Bishop v. State*, 462 S.E.2d 716 (Ga. 1995) (separation of powers, equal protection, and due process challenge); *People v. M.A.*, 529 N.E.2d 492 (Ill. 1988) (due process and equal protection challenge);

III. THE ROLE OF PROSECUTORIAL DISCRETION

Prosecutorial discretion, of course, is one of the five methods mentioned above by which jurisdiction is allocated between juvenile court and criminal court, resulting in some juveniles being prosecuted as adults.⁶⁶ Reference to prosecutorial discretion above, however, is to a model in which the prosecutor is expressly authorized by statute to make the decision whether to file an information or seek an indictment in criminal court or to file a petition in juvenile court.⁶⁷ A more generic form of prosecutorial discretion exists that is much more pervasive than the prosecutorial model mentioned above.

Specifically, with the exception of the prosecutorial model, all of the above models *appear* to involve either judicial decision making (whether by the juvenile court or by the criminal court) or legislative decision making, or some combination of the two. In truth, however, all of these models involve an exercise of prosecutorial discretion. For example, in the case of judicial waiver and transfer—whether by the juvenile court or the criminal court—the prosecutor decides what charge to file. The prosecutor may file a charge alleging an offense or degree of offense that qualifies the juvenile for transfer by the juvenile court or that causes the case to originate in criminal court. Likewise, in a state that employs the concurrent juris-

State v. Perique, 439 So. 2d 1060 (La. 1983) (due process challenge); State v. Leach, 425 So. 2d 1232 (La. 1983) (equal protection challenge); *In re Boot*, 925 P.2d 964 (Wash. 1996) (equal protection, due process and Eighth Amendment challenge); *see also* State v. Berard, 401 A.2d 448 (R.I. 1979) (due process and equal protection challenge). Statutes that require mandatory waiver and transfer of certain cases likewise have been upheld against similar claims. *See, e.g.*, State v. Angel C., 715 A.2d 652 (Conn. 1998); People v. R.L., 634 N.E.2d 733 (Ill.), *cert. denied*, 513 U.S. 918 (1994); People v. Black, 513 N.W.2d 152 (Mich. Ct. App. 1994); State v. A.L., 638 A.2d 814 (N.J. Super. Ct. 1994); A.B. v. State, 936 P.2d 1091 (Utah Ct. App. 1997). *But see* Hughes v. State, 653 A.2d 241 (Del. 1994). The “once waived, always waived” statutes also have been upheld. *See, e.g.*, State v. Sharon, 668 P.2d 584 (Wash. 1983), *affg* 655 P.2d 1193 (Wash. Ct. App. 1982); *see also* Hangen v. State, 651 So. 2d 706 (Fla. Dist. Ct. App. 1995); Broadnax v. Commonwealth, 485 S.E.2d 666 (Va. Ct. App. 1997).

⁶⁶ *See supra* pp. 11-13.

⁶⁷ *See supra* notes 44-47, 56, 59 and accompanying text.

diction model or that excludes some offenses from the juvenile court's jurisdiction, the prosecutor, by electing to charge a qualifying offense, can determine the court to which the case will be sent.

For example, if certain offenses are excluded from the juvenile court's jurisdiction, the prosecutor could file a charge alleging a more serious degree of the offense, even though the evidence would support only a lesser offense, just to get the case into criminal court. Prosecutorial discretion, therefore, plays a dominant and powerful role in the decision-making process by which some cases involving juveniles end up in criminal court.⁶⁸ Wherever such power is present, the potential for abuse is great. Prosecutors often are moved by political expediency, especially in high profile cases, e.g., the school shooting cases.⁶⁹

On the last day of the school year—May 26, 2000—thirteen-year-old Nathaniel Brazill shot and killed one of his teachers at a middle school in Lake Worth, Florida.⁷⁰ That was on Friday afternoon. On Sunday the state attorney announced he would seek an indictment to have the thirteen-year-old student tried as an adult.⁷¹ Two weeks later the grand jury returned an indictment for first-degree murder.⁷² Trial has been set for March 5, 2001.⁷³

⁶⁸ Others have noticed the not-so-subtle shift from judicial decision making to prosecutorial decision making as the dominant model today. See ZIMRING, *supra* note 2, at 117-27.

⁶⁹ Tragedies such as those that occurred at schools in Pearl, Mississippi; West Paducah, Kentucky; Jonesboro, Arkansas; Springfield, Oregon; and perhaps the most horrific of all, at Columbine High School in Littleton, Colorado, are highly publicized and evoke strong public reaction. See generally W. David Watkins & John S. Hooks, *The Legal Aspects of School Violence: Balancing School Safety with Students' Rights*, 69 MISS. L.J. 641 (1999).

⁷⁰ Joel Engelhardt, *Florida Teen Held in Killing of Teacher: Police say student sent home earlier*, ATLANTA JOURNAL-CONSTITUTION, May 27, 2000, at A4.

⁷¹ Michael Browning, *State: Try Brazill As Adult: Krischer wants quick action by grand jury*, PALM BEACH POST, May 29, 2000, at 1A.

⁷² Noah Bierman & Susan Spencer-Wendel, *Brazill Indicted As Adult: The 13-year-old faces murder, assault charges*, PALM BEACH POST, June 13, 2000, at 1A.

⁷³ Susan Spencer-Wendel, *Request to Speed Up Brazill Case Denied: Trial set for March*, PALM BEACH POST, Sept. 29, 2000, at 4B.

As mentioned previously, in Florida the prosecutor has discretion to seek an indictment in the case of a minor of any age charged with an offense punishable by death or life imprisonment.⁷⁴ Some 6,000 of Florida's nearly 95,000 juvenile cases are filed directly in criminal court by prosecutors,⁷⁵ nearly matching the total number of cases that are transferred to criminal court by judges in all other states combined.⁷⁶ Despite the fact that Florida is aggressive in seeking adult treatment of juveniles generally, the high profile cases are the ones that attract their attention.⁷⁷

The high-profile cases are not limited to the school shooting cases. Other examples abound, for example, the Richard Jahnke case mentioned earlier.⁷⁸ Another example is that of

⁷⁴ See *supra* note 56 and accompanying text.

⁷⁵ Douglas Kalajian, *Florida Kids: Adult Crime, Adult Time: State leads nation in prosecuting teens*, PALM BEACH POST, June 4, 2000, at 1A. In addition to minors of any age charged with an offense punishable by death or life imprisonment, Florida also allows prosecutors discretion to seek an indictment against juveniles 16 or older charged with any offense and juveniles 14 or older charged with one of certain enumerated serious offenses. See *supra* note 59 and accompanying text.

⁷⁶ Kalajian, *supra* note 75, at 1A.

⁷⁷ Only one other murder defendant as young as Nathaniel Brazill was prosecuted for murder during the current state attorney's seven-year tenure, and he would be the youngest Palm Beach County resident ever sentenced to life imprisonment if he is convicted. *Id.*

⁷⁸ See *supra* notes 49-51 and accompanying text. One of the earliest cases was that of 14-year-old Caril Ann Fugate, who accompanied her boyfriend Charles Starkweather on a multi-state killing spree that attracted widespread media attention during the 1950s. She was prosecuted as an adult, convicted of second-degree murder, and sentenced to life imprisonment. See *Fugate v. Ronin*, 91 N.W.2d 240 (Neb. 1958). Her conviction was upheld in a case that involved a jurisdictional dispute over whether she was properly tried in adult court or should instead have been handled as a juvenile in juvenile court. *Fugate*, 91 N.W.2d at 245. At age 15 Caril Ann Fugate was the youngest woman ever sentenced to life in prison. She was paroled in 1976. Charles Starkweather was executed in the electric chair in 1959. See Fred Thomas, *Three on TV Show Support Her Innocence: Caril Fugate called pawn in '58 murder spree*, OMAHA WORLD-HERALD, Nov. 7, 1989, at 11; *Caril Ann Fugate Says Nebraskans Were Wrong About Her Role*, OMAHA WORLD-HERALD, Nov. 6, 1989, at 3. Maintaining her innocence throughout her arrest, trial, imprisonment, and the period since her parole, Fugate petitioned for a pardon in 1996, but her request was denied. See Paul Hammel, *Caril Ann Fugate Loses Bid for Pardon*, OMAHA WORLD-HERALD, Aug. 9, 1996, at 1.

nine-year-old Cameron Kocher, who found himself prosecuted for murder in criminal court in Pennsylvania for shooting and killing a playmate with his father's hunting rifle.⁷⁹ Murder is one of the offenses that, under Pennsylvania law, originates in criminal court, which has discretion to transfer appropriate cases to juvenile court.⁸⁰ The Pennsylvania Supreme Court held that the trial court abused its discretion in denying the nine-year-old defendant's request to have his case transferred to juvenile court.⁸¹ Two justices concurred in the court's judgment on the ground that, as a policy matter, a nine-year-old child may not be criminally prosecuted for murder.⁸² The case thus involved an improper exercise of judicial rather than prosecutorial discretion, but one might question whether the nine-year-old boy should have been charged with murder at all. He subsequently pleaded no contest to involuntary manslaughter and was placed on probation for eight years.⁸³

IV. PUNITIVE TRENDS IN DISPOSITIONAL ALTERNATIVES

The preceding discussion focused on the trend toward an increasing number of juveniles being prosecuted as adults. In the juvenile court itself, a similar trend toward more punitive treatment has emerged as well. Some states allow punitive dispositional options for the juvenile court. The options briefly discussed below are options for the juvenile court only, following adjudication of delinquency in the juvenile court. Punitive options are available to criminal courts, of course, including the option of the death sentence,⁸⁴ but criminal sentencing options are not the subject of this article. This article is con-

⁷⁹ *Commonwealth v. Kocher*, 602 A.2d 1308 (Pa. 1992).

⁸⁰ See *supra* statute cited note 36.

⁸¹ *Kocher*, 602 A.2d at 1315.

⁸² *Id.* (Flaherty, J., concurring).

⁸³ Barbara White Stack, *Children Who Kill Protected by Law: 6-year-olds incapable of criminal intent*, PITTSBURGH POST-GAZETTE, Mar. 2, 2000, at A12.

⁸⁴ The death penalty for minors, as well as sentences such as life without possibility of parole, is discussed more fully in SAMUEL M. DAVIS, *RIGHTS OF JUVENILES: THE JUVENILE JUSTICE SYSTEM* at § 6.11 (2d ed. 2000) [hereinafter cited as DAVIS, *RIGHTS OF JUVENILES*].

cerned only with the trend toward more punitive options available in juvenile court.

A. *The Texas Statutory Scheme*

The Texas statutory scheme represents the most punitive approach in sentencing of juvenile offenders who have been adjudicated delinquent by the juvenile court. Texas allows commitment of certain juveniles to a correctional facility for a determinate period of up to forty years.⁸⁵ In the case of any minor charged with one of certain enumerated offenses, the prosecutor may refer the case to the grand jury,⁸⁶ and if the grand jury approves the prosecutor's petition, its approval is certified to the juvenile court.⁸⁷ If the minor is adjudicated delinquent for an enumerated offense, he or she may be committed to the Texas Department of Criminal Justice for a determinate period of up to forty years.⁸⁸ Initial commitment is to the Texas Youth Commission, but the statutory scheme provides for transfer to the Texas Department of Criminal Justice when the minor reaches the age of sixteen.⁸⁹

The Texas statutory scheme has been upheld against equal protection claims, the court each time concluding that the statutory scheme furthers the state's compelling interest in balancing the need to protect minors on the one hand and the need to protect and guarantee public safety on the other hand.⁹⁰ Texas courts likewise have upheld that part of the statutory scheme allowing transfer to the Department of Criminal Justice at age sixteen against claims that it violates equal protection, due process, the prohibition against double jeopardy, and the separation of powers doctrine.⁹¹ Transfer

⁸⁵ TEX. FAM. CODE ANN. § 54.04(d)(3) (West 1996).

⁸⁶ *Id.* § 53.045(a) (West Supp. 2000).

⁸⁷ *Id.* § 53.045(b), (d) (West 1996).

⁸⁸ *Id.* § 54.04(d)(3).

⁸⁹ *Id.* § 54.11; TEX. HUM. RES. CODE ANN. §§ 61.079, 61.084 (West Supp. 2000).

⁹⁰ See *In re S.B.C.*, 805 S.W.2d 1, 4 (Tex. App. 1991); *In re R.L.H.*, 771 S.W.2d 697, 701 (Tex. App. 1989) (finding compelling state interest in striking balance between two goals).

⁹¹ See *In re T.D.H.*, 971 S.W.2d 606 (Tex. App. 1998); *In re J.G.*, 905 S.W.2d

decisions also have been upheld against non-constitutional claims as well, e.g., that the decision to transfer constituted an abuse of the court's discretion.⁹²

B. "Juvenile Life" Statutory Schemes

Louisiana authorizes the juvenile court to impose a disposition of "juvenile life," i.e., commitment of a juvenile not only for the remainder of his or her minority but until age twenty-one without possibility of parole, probation, or other early release.⁹³ This statute represents the juvenile counterpart to life without possibility of parole in the adult system, but only until the offender reaches age twenty-one. The Louisiana Court of Appeals has upheld the statutory scheme, holding that a commitment for "juvenile life" was not excessive in the case of a thirteen-year-old juvenile adjudicated delinquent for rape of an eleven-year-old girl.⁹⁴

Illinois also provides for mandatory commitment to the Department of Corrections until age twenty-one, without possibility of parole or early release, in the case of a juvenile adjudicated a habitual juvenile offender or a violent juvenile offender.⁹⁵ Habitual and violent juvenile offenders are juveniles who are repeat offenders now charged with one of several enumerated serious offenses.⁹⁶ The violent juvenile offender statutory scheme has been upheld against due process and equal protection claims.⁹⁷

676 (Tex. App. 1995).

⁹² Garrett v. State, 847 S.W.2d 268 (Tex. App. 1992). One commentator has argued that a preferable alternative to the Texas determinate sentencing scheme would be a statutory scheme creating a presumption of adult treatment for the most serious juvenile offenders. Tamara L. Reno, Comment, *The Rebuttable Presumption for Serious Juvenile Crimes: An Alternative to Determinate Sentencing in Texas*, 26 TEX. TECH. L. REV. 1421, 1459 (1995).

⁹³ LA. CHILDREN'S CODE ANN. art. 897.1(A) (West Supp. 2001).

⁹⁴ State v. A.A.S., 711 So. 2d 319 (La. Ct. App. 1998).

⁹⁵ 705 ILL. COMP. STAT. ANN. 405/5-815(f), 405/5-820(f) (West 1999).

⁹⁶ *Id.* 405/5-815(a), 405/5-820(a).

⁹⁷ People v. M.G., 703 N.E.2d 594 (Ill. App. Ct. 1998). For application of the habitual juvenile offender statute, see *People v. S.P.*, 696 N.E.2d 739 (Ill. App. Ct. 1998).

C. Restrictive Placement

Although not quite as rigid as the Louisiana or Illinois statutory schemes, some states authorize "restrictive placement" of certain juveniles. For example, in New York a minor adjudicated delinquent for committing a Class A felony at thirteen to fifteen years of age may be committed to the Division for Youth for an initial period of five years, the first twelve to eighteen months of which must be spent in a secure facility and the second twelve months of which are spent in a residential facility, without possibility of release from either facility during the separate periods of confinement.⁹⁸ Motion for discharge from placement with the Division for Youth cannot be made until three years of the five-year period have elapsed.⁹⁹

A minor adjudicated delinquent for committing a designated felony other than a Class A felony while thirteen to fifteen years of age may be committed to the Division for Youth for an initial period of three years, the first six to twelve months of which must be spent in a secure facility, followed by a period of six to twelve months in a residential facility, with no possibility of early release from either facility during these periods.¹⁰⁰ No motion for early discharge is permitted under this option.¹⁰¹

Other states have similar restrictive placement schemes.¹⁰² New York's statutory scheme has been upheld.¹⁰³

⁹⁸ New York Family Court Act, N.Y. JUD. LAW §§ 301.2(8)-(11), 353.5(1)-(4) (McKinney 1999).

⁹⁹ *Id.*

¹⁰⁰ *Id.* § 353.5(5).

¹⁰¹ *Id.*

¹⁰² See, e.g., GA. CODE ANN. § 15-11-63 (Supp. 2000) (requiring initial custody period of five years); VA. CODE ANN. § 16.1-285.1 (Michie 1999) (providing for commitment period not exceeding seven years).

¹⁰³ *In re Quinton A.*, 402 N.E.2d 126 (N.Y. 1980).

D. Determinate Dispositions

One of the traditional hallmarks of the juvenile court was the indeterminate disposition model, which still prevails in most jurisdictions.¹⁰⁴ Under this dispositional scheme, if the juvenile is to be committed to the youth authority, the commitment is for an indeterminate period. The court may designate the agency or department to which the minor is to be committed, but it generally cannot designate the particular institution to which he or she is to be sent, nor the particular treatment regimen in which the minor will participate.¹⁰⁵ The youth authority, not the court, determines when the minor is released from care.¹⁰⁶

In recent years, however, influenced perhaps by the IJA/ABA Juvenile Justice Standards,¹⁰⁷ some states have moved toward determinate dispositions based on the seriousness of the offense committed.¹⁰⁸ The clearest example of the movement toward determinate *commitment* is the statutory scheme in Washington. Washington adopted a series of legisla-

¹⁰⁴ See, e.g., ALASKA STAT. § 47.12.120(b)(1) (Michie 1998) (providing numerous options for disposition); CONN. GEN. STAT. ANN. § 46b-141 (West Supp. 2000) (outlining indeterminate time frame for commitment); IDAHO CODE § 20-520(1) (1997) (requiring determination of sentence that will "promote accountability, competency, development, and community protection").

¹⁰⁵ See, e.g., *State v. S.T.*, 699 So. 2d 1128 (La. Ct. App. 1997) (holding court unauthorized to determine where child should be placed); see also *State v. K.D.*, 730 So. 2d 1077 (La. Ct. App. 1999) (affirming *In re S.T.*, holding that court has no authority to designate type of treatment).

¹⁰⁶ See, e.g., *Mack v. State*, 188 S.E.2d 828 (Ga. Ct. App. 1972); *Mississippi Dep't of Human Servs. v. Forrest County Youth Court*, 663 So. 2d 580 (Miss. 1995); *In re B.L.T.*, 853 P.2d 1226 (Mont. 1993); *State ex rel. G.W.R. v. Scott*, 317 S.E.2d 504 (W. Va. 1984).

¹⁰⁷ INSTITUTE OF JUDICIAL ADMINISTRATION & AMERICAN BAR ASSOCIATION, JUVENILE JUSTICE STANDARDS PROJECT, STANDARDS RELATING TO DISPOSITIONS, Standards 1.1, 1.2, 3.2 and Commentary to Standard 1.1 at 15-20 (1980). Abandonment of the rehabilitative ideal was criticized by some of the drafters of the Standards. *Id.* at 133-35 (dissenting views of Hon. Justine Wise Polier and Commissioner Patricia M. Wald). Specific periods of confinement, proportional to the seriousness of the offense, are found at *id.*, STANDARDS RELATING TO JUVENILE DELINQUENCY AND SANCTIONS, Standard 5.2(A).

¹⁰⁸ See, e.g., KY. REV. STAT. ANN. § 635.085(1) (Michie 1999); N.C. GEN. STAT. §§ 7B-2506(5), (6), (23) (1999).

tive proposals that focused on accountability, including a new statement of purpose that evoked a punitive rationale.¹⁰⁹ As part of this package, Washington adopted sentencing guidelines, providing for commitment within certain ranges set by a state board, as well as commitment beyond the normal range in certain cases.¹¹⁰ The statutes also provide for the setting of release dates in accordance with guidelines similar to those set for adult parole.¹¹¹

In any event, whether the disposition is commitment, payment of a fine, or performing hours of community service, the period of confinement, the amount of the fine, or the number of hours of community service to be performed is finite and is keyed directly to the seriousness of the offense.¹¹² The determinate approach, of course, reflects the concept of proportionality, the notion that the punishment should fit the crime.

¹⁰⁹ WASH. REV. CODE ANN. § 13.40.010(2)(c)-(d) (West 1993 & Supp. 2000). The shift from a rehabilitative statement of purpose to one that spoke of accountability and punishment prompted a renewed claim in Washington that because of the change, juveniles were now entitled to jury trials. *State v. Lawley*, 591 P.2d 772 (Wash. 1979). The Washington Supreme Court rejected this argument, concluding that despite the new legislation, the overall purpose of the juvenile process remained rehabilitative in nature. *Lawley*, 591 P.2d at 774. In the wake of the *Lawley* decision, another juvenile challenged a juvenile court's order that he perform public service, on the ground that it constituted involuntary servitude in violation of the Constitution. *In re Erickson*, 604 P.2d 513 (Wash. Ct. App. 1979). The Washington Court of Appeals rejected his claim, holding that the disposition was "punishment for crime" and therefore did not fall within the constitutional prohibition against involuntary servitude. *In re Erickson*, 604 P.2d at 514.

¹¹⁰ WASH. REV. CODE ANN. §§ 13.40.030, 13.40.0354 (repealed 2000), 13.40.0357, 13.40.160 (West Supp. 2000); see KAN. STAT. ANN. § 38-16,129 (Supp. 1999) (outlining placement based on offense). Cf. TENN. CODE ANN. § 37-1-137(a)(1)(B), (h) (1996) (permitting determinate commitment of some juveniles in accordance with adult sentencing guidelines). In *State v. Taylor*, 709 P.2d 1207, 1209 (Wash. Ct. App. 1985), the court applied these sentencing guidelines and concluded that a commitment of 65 weeks, outside the standard range of 30 days, was appropriate. *State v. N.E.*, 854 P.2d 672 (Wash. Ct. App. 1993), further illustrates the court's authority to impose a term of commitment outside the standard range where a disposition within the standard range would "effectuate a manifest injustice." *N.E.*, 854 P.2d at 673.

¹¹¹ WASH. REV. CODE ANN. §§ 13.40.205, 13.40.210 (West 1993 & Supp. 2000).

¹¹² See, e.g., KY. REV. STAT. ANN. § 635.085(1) (Michie 1999) (outlining fine schedule); N.C. GEN. STAT. § 7B-2506(5), (6), (23) (1999) (setting fines and community service keyed to seriousness of offense).

It is clearly a "just desserts" model, a punitive model traditionally associated with the criminal process.¹¹³

V. THE "PHANTOM MENACE"

What explains the movement toward more punitive treatment of juveniles? The trend is explained in large part by a *perception* that youth crime is rampant, that it is growing by the minute, that it is out of control, spinning off the charts.¹¹⁴ Public pressure, therefore, is on legislators to address what is perceived as a worsening general pattern of violent juvenile crime. Legislators have responded by enacting legislation designed to "get tough" on juvenile crime.¹¹⁵

The problem with this perception, however, is that it is just wrong. States have been enacting laws to deal with a worsening pattern of juvenile crime that does not exist.

In his recently published book, *American Youth Vio-*

¹¹³ For an argument that the trend toward "get tough" legislation does not signal the demise of the rehabilitative ideal and that rehabilitation and punitive goals are compatible in an integrated system for dealing with serious and habitual juvenile offenders, see Julianne P. Sheffer, Note, *Serious and Habitual Juvenile Offender Statutes: Reconciling Punishment and Rehabilitation Within the Juvenile Justice System*, 48 VAND. L. REV. 479 (1995). Likewise, it has been argued that rehabilitation and punishment are not mutually exclusive, that punishment rather is one of the means toward rehabilitative ends. Catherine J. Ross, *Disposition in a Discretionary Regime: Punishment and Rehabilitation in the Juvenile Justice System*, 36 B.C. L. REV. 1037 (1995). Debate over whether the rehabilitative ideal has continuing currency, of course, has fueled calls for abolition of the juvenile court as well as responses to the arguments for abolition. See articles cited *supra* note 3.

¹¹⁴ See generally ZIMRING, *supra* note 2, at 3-16 (discussing "perception" problem).

¹¹⁵ *Id.* at 11-16. For a critical analysis of legislative changes in Utah, see Michael Norman & L. Kay Gillespie, *Changing Horses: Utah's Shift in Adjudicating Serious Juvenile Offenders*, 12 J. CONTEMP. L. 85 (1986). Oklahoma's adoption of a reverse certification scheme was criticized in Cornish, *supra* note 37. Following adoption of a reverse certification model in New York, the statutory scheme was criticized for not going far enough. See Whisenand & McLaughlin, *supra* note 3. It was criticized again on the ground that if its purpose was deterrence, it had been a failure. See Simon I. Singer & David McDowall, *Criminalizing Delinquency: The Deterrent Effects of the New York Juvenile Offender Law*, 22 L. & SOC'Y REV. 521 (1988).

lence,¹¹⁶ Frank Zimring examines the data on arrest rates for juveniles between the ages of thirteen and seventeen in four major crime categories—homicide, aggravated assault, rape, and robbery—between 1980 and 1996.¹¹⁷ He concludes that there is no sustainable pattern of juvenile arrests—either up or down—during this period.¹¹⁸ They go up. They go down. In fact, over the last five years of this period juvenile arrests have gone down in all four major crime categories.¹¹⁹

The myth is perpetuated, Zimring says, based on what he describes as “the coming storm” prediction.¹²⁰ It has three parts: First, the claim that while violent crime rates generally are stable or are decreasing, the rates for juvenile offenders are on the rise; second, the prediction that the problem is going to get worse in future years because of a dramatic growth in the number of teenagers; and third, the conclusion that an increase in violent juvenile crime is inevitable and that we must prepare, therefore, for “the coming storm” of violent juvenile crime.¹²¹ Zimring spends three chapters challenging and at times refuting the evidence on which these dire predictions are based,¹²² and he ultimately concludes that the pronouncement that we are in the midst of an epidemic of violent juvenile crime is just not so.¹²³

This is not the first time such “crises” have been announced, Zimring points out.¹²⁴ They have occurred at least twice previously in the last thirty years—once in the mid- to late 1970s and now the current “crisis,” which began in the

¹¹⁶ ZIMRING, *supra* note 2.

¹¹⁷ *Id.* at 31-35.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 32, Figure 3.1.

¹²⁰ *Id.* at 4-5.

¹²¹ ZIMRING, *supra* note 2, at 5-6.

¹²² *Id.* at 17-65.

¹²³ *Id.* at 45-47, 60-64. Zimring suggests that the specter of an epidemic of violent youth crime may be fueled by the news media. *Id.* at 181. Others have agreed. See, e.g., Robert E. Shepherd, Jr., *Film at Eleven: The News Media and Juvenile Crime*, 18 QUINNIPIAC L. REV. 687 (1999).

¹²⁴ ZIMRING, *supra* note 2, at 6.

early 1990s.¹²⁵ On both occasions, he says, fear of "the coming storm" of juvenile crime evoked a flurry of "get tough" legislative responses.¹²⁶ After dispelling the myth that violent juvenile crime is rampant, he criticizes the "get tough" legislation that has characterized the public policy response.¹²⁷ Historical perspective, he says, shows that arrest rates fluctuate in cyclical patterns, making any predictions of future behavior based on past arrest rates a flawed response.¹²⁸ He urges rather that any policy-making regarding juveniles be based on an accurate assessment of what the data actually show when measured against the backdrop of historical perspective.¹²⁹

VI. APPROPRIATE RESPONSES TO THE PROBLEM

If the burst of "get tough" legislation enacted in response to a wave of violent juvenile crime that does not exist was ill-advised, what can or should be done about it? It would be unrealistic to expect that the same legislators who enacted the laws, on learning that their actions were based on a nonexistent threat, will set about to repeal those laws on the next available occasion. They probably would be seen as soft on crime if they did the unthinkable, given the popular perception that, in fact, violent juvenile crime is on the rise. Given that set of realities, what safeguards can be created to mitigate overzealous prosecution of juveniles in adult court?

A. *Institution of a Probable Cause Requirement*

Certainly some juveniles accused of crime ought to be prosecuted as adults in criminal court. The challenge is to develop a process to ensure that cases that ought to be handled in criminal court do end up there, and cases that more appropriately ought to be handled in juvenile court are, in

¹²⁵ *Id.*

¹²⁶ *Id.* at 4.

¹²⁷ *Id.* at 11-16.

¹²⁸ *Id.* at 45-47.

¹²⁹ ZIMRING, *supra* note 2, at 194-95.

fact, handled in juvenile court. This article has spent a great deal of time discussing several of those processes. One of them, of course, is the process by which the juvenile court decides which juveniles should be prosecuted as adults.¹³⁰ In such cases a waiver hearing is held in juvenile court. The waiver hearing, which is generally regarded as being required by due process of law¹³¹ and in any event typically is required by statute,¹³² is a safeguard in itself. At the hearing, evidence usually is presented to establish probable cause¹³³ as well as to determine whether the juvenile is amenable to

¹³⁰ See *supra* notes 28-32 and accompanying text.

¹³¹ *Kent v. United States*, 383 U.S. 541 (1966). Initially, *Kent* seemed to be based on an interpretation of the District of Columbia waiver statute, but subsequent references to *Kent* in *In re Gault*, 387 U.S. 1 (1967), seemed to put *Kent* squarely on constitutional footing. Most courts favor that conclusion. See, e.g., *Powell v. Hocker*, 453 F.2d 652 (9th Cir. 1971); *United States ex rel. Turner v. Rundle*, 438 F.2d 839, 842 (3d Cir. 1971), and cases cited therein at 842 n.11; *In re Harris*, 434 P.2d 615 (Cal. 1967); see also *People v. Fields*, 186 N.W.2d 15 (Mich. Ct. App. 1971), *rev'd on other grounds*, 199 N.W.2d 217 (Mich. 1972). But see *Stanley v. Peyton*, 292 F. Supp. 209 (W.D. Va. 1968); *State v. Acuna*, 428 P.2d 658 (N.M. 1967); *In re Bullard*, 206 S.E.2d 305 (N.C. Ct. App. 1974); *Cradle v. Peyton*, 156 S.E.2d 874 (Va. 1967), *cert. denied*, 392 U.S. 945 (1968).

¹³² See, e.g., ALA. CODE § 12-15-34(b) (1995 & Supp. 2000); COLO. REV. STAT. § 19-2-518(1)(a)(II)(b) (2000); DEL. CODE ANN. tit. 10, § 1010(b) (1999); D.C. CODE ANN. § 16-2307(d) (1981 & Supp. 2000); FLA. STAT. ANN. § 985.226(3)(c) (West Supp. 2001); GA. CODE ANN. § 15-11-30.2(a)(1) (Supp. 2000); HAW. REV. STAT. § 571-22(a)-(b), (d) (1993 & Supp. 1999); IDAHO CODE § 20-508(1) (1997); 705 ILL. COMP. STAT. ANN. 405/5-805 (West 1999 & Supp. 2000); IND. CODE ANN. §§ 31-30-3-2 to -6 (Michie 1997 & Supp. 2000); IOWA CODE ANN. § 232.45(2) (West 2000); ME. REV. STAT. ANN. tit. 15, § 3101(4)(A) (West 1980); MD. CODE ANN., CTS. & JUD. PROC. § 3-817(b) (1998 & Supp. 2000); MICH. COMP. LAWS ANN. § 712A.4(4) (West 1993 & Supp. 2000); MINN. STAT. ANN. § 260B.125(2)(4) (West Supp. 2001); N.J. STAT. ANN. § 2A:4A-26(a) (West 1987 & Supp. 2000); N.C. GEN. STAT. §§ 7B-2200, 7B-2202 (1999); N.D. CENT. CODE § 27-20-34(1)(c)(2) (Supp. 1999); OHIO REV. CODE ANN. § 2151.26(B) (Anderson 1998); OKLA. STAT. ANN. tit. 10, § 7303-4.3(B) (West 1998); 42 PA. CONS. STAT. ANN. § 6355(a)(2) (West 2000); S.D. CODIFIED LAWS § 26-11-4 (Michie 1999); TENN. CODE ANN. § 37-1-134(a)(2) (1996 & Supp. 2000); TEX. FAM. CODE ANN. § 54.02(c) (West 1996 & Supp. 2001); UTAH CODE ANN. § 78-3a-603(1) (1996 & Supp. 2000); VA. CODE ANN. § 16.1-269.1(A) (Michie 1999); WYO. STAT. ANN. § 14-6-237(a) (Michie 1999).

¹³³ See, e.g., GA. CODE ANN. § 15-11-30.2(a)(3)(A) (Supp. 2000); N.C. GEN. STAT. §§ 7B-2200, 7B-2202 (1999); N.D. CENT. CODE § 27-20-34(1)(c)(4)(a) (Supp. 2000); OHIO REV. CODE ANN. § 2151.26(B) (Anderson 1998); VA. CODE ANN. § 16.1-269.1(A)(2) (Michie 1999).

juvenile treatment.¹³⁴ In some instances, for example in those states that allow reverse certification, courts have required a waiver hearing in criminal court where the court is considering a possible transfer to juvenile court.¹³⁵

Whether in juvenile court or criminal court, the waiver hearing serves a valuable screening function in the exercise of judicial discretion and is thus an important safeguard. That safeguard is not present, however, in the exercise of prosecutorial discretion. Courts generally have held that no waiver hearing is constitutionally required in the exercise of prosecutorial discretion, distinguishing *Kent v. United States*¹³⁶ on the ground that it dealt only with exercise of judicial discretion.¹³⁷ In the absence of a waiver hearing, some alternative safeguard is needed as a protection against unbridled prosecutorial discretion.

One additional safeguard against overzealous prosecution is to require a probable cause determination by the criminal court when a case either originates in criminal court or is transferred there from the juvenile court.¹³⁸ The criminal

¹³⁴ Most waiver statutes now reflect criteria that go to the amenability determination. See, e.g., ALASKA STAT. § 47.12.100(b) (Michie 1998); D.C. CODE ANN. § 16-2307(e) (Supp. 2000); FLA. STAT. ANN. § 985.226(3)(c) (West Supp. 2001); 705 ILL. COMP. STAT. ANN. 405/5-805(3)(b) (West 1999 & Supp. 2000); OKLA. STAT. ANN. tit. 10, § 7303-4.3(B) (West 1998); TEX. FAM. CODE ANN. § 54.02(f) (West Supp. 2001); see also ALA. CODE § 12-15-34(d) (Supp. 2000); MD. CODE ANN., CTS. & JUD. PROC. § 3-817(d) (Supp. 2000); MICH. COMP. LAWS ANN. § 712A.4(4) (West 1993 & Supp. 2000).

¹³⁵ See, e.g., *State v. Terry*, 569 N.W.2d 364 (Iowa 1997); *Jones v. State*, 586 A.2d 55 (Md. Ct. Spec. App. 1991); *State v. Woodward*, 737 P.2d 569 (Okla. Crim. App.), modified, 745 P.2d 1180 (Okla. Crim. App. 1987); *Commonwealth v. Pyle*, 342 A.2d 101 (Pa. 1975); *State v. Verhagen*, 542 N.W.2d 189 (Wis. Ct. App. 1995). The burden is on the juvenile in these cases, however, to prove that he is amenable to juvenile treatment. A later version of the Pennsylvania statute approved in *Commonwealth v. Pyle*, also placing the burden on the juvenile to show by a preponderance of evidence that transfer to juvenile court would serve the public interest, was upheld in *Commonwealth v. Cotto*, 753 A.2d 217 (Pa. 2000).

¹³⁶ 383 U.S. 541 (1966).

¹³⁷ See, e.g., *Woodard v. Wainwright*, 556 F.2d 781 (5th Cir. 1977); *Russell v. Parrott*, 543 F.2d 1214 (8th Cir. 1976); *Cox v. United States*, 473 F.2d 334 (4th Cir. 1973); *People v. Sprinkle*, 307 N.E.2d 161 (Ill. 1974).

¹³⁸ Such a requirement has been urged previously. See Samuel M. Davis, *The Efficacy of a Probable Cause Requirement in Juvenile Proceedings*, 61 N.C. L.

court should hold a probable cause hearing to determine whether there is probable cause to believe that the juvenile has committed an offense at least as serious as the one with which he is charged. In New York, for example, if a juvenile who is charged with an offense over which the criminal court has original jurisdiction¹³⁹ is arraigned prior to action by the grand jury, he or she is entitled to a probable cause hearing.¹⁴⁰ If probable cause to believe the juvenile has committed an enumerated offense is found, the case is bound over to the appropriate court for action by the grand jury.¹⁴¹ If probable cause that the juvenile committed a lesser offense over which the family court would have exercised original jurisdiction is found, the case is transferred to family court.¹⁴² If no probable cause is found to believe the juvenile committed an offense of any kind, the case is dismissed.¹⁴³

Statutory and case law in a related area are instructive here as well. Suppose, following discretionary transfer from juvenile court, a juvenile is charged with, pleads guilty to, or is convicted of a lesser included offense.¹⁴⁴ Does the criminal court or the juvenile court have jurisdiction over the juvenile at that point? The prevailing view appears to be that the criminal court retains jurisdiction in any of these events.¹⁴⁵ The same result follows if the case is in criminal court for some

REV. 723, 740-44 (1981) [hereinafter cited as Davis].

¹³⁹ See *supra* note 34 and accompanying text.

¹⁴⁰ N.Y. CRIM. PROC. LAW § 180.75(1)-(3) (McKinney 1993).

¹⁴¹ *Id.* § 180.75(3)(a).

¹⁴² *Id.* § 180.75(3)(b).

¹⁴³ *Id.* § 180.75(3)(c).

¹⁴⁴ "Lesser included offense" refers to an offense that is not an enumerated offense that would have qualified the case for transfer to criminal court, or an offense that would have caused the case to originate in criminal court.

¹⁴⁵ See, e.g., DEL. CODE ANN. tit. 10, §§ 921(2)(b), 1010(d) (1999 & Supp. 2000); LA. CHILDREN'S CODE ANN. art. 863(A) (West 1995); *State v. Morales*, 694 A.2d 758 (Conn. 1997); *Commonwealth v. Williams*, 691 N.E.2d 553 (Mass. 1998); *Castro v. State*, 703 S.W.2d 804 (Tex. App. 1986). But see *State v. Torres*, 538 A.2d 185 (Conn. 1988) (where criminal court found lack of probable cause to sustain murder charge, on basis of which juvenile had been transferred and state substituted an information charging manslaughter, manslaughter charge should have been remanded to juvenile court).

other reason, for example, the offense charged is one that is excluded from the juvenile court's jurisdiction,¹⁴⁶ the case is one that must originate in criminal court,¹⁴⁷ or the case is one that calls for mandatory waiver and transfer to the criminal court.¹⁴⁸

Not all states agree. In some, if the case is transferred to the criminal court and the juvenile is not charged by accusatory instrument with a waivable offense in criminal court, the case must be remanded to the juvenile court.¹⁴⁹ The same would seem to hold true for cases that are in the criminal court for some reason other than transfer from juvenile court, for example, where the criminal court has original jurisdiction over an offense excluded from the juvenile court's jurisdiction.¹⁵⁰ Some states also provide that if the juvenile is convicted of a lesser included offense, he or she must be remanded to the juvenile court for disposition.¹⁵¹

¹⁴⁶ See, e.g., IND. CODE ANN. § 31-30-1-4 (Michie 1997); *People v. Luckett*, 692 N.E.2d 1345 (Ill. App. Ct. 1998); *State v. Behl*, 564 N.W.2d 560 (Minn. 1997).

¹⁴⁷ See, e.g., *Lucas v. United States*, 522 A.2d 876 (D.C. 1987); *Williams v. State*, 459 So. 2d 777 (Miss. 1984).

¹⁴⁸ See, e.g., *People v. Self*, 73 Cal. Rptr. 2d 501 (Cal. Ct. App. 1998); *People v. Parrish*, 549 N.W.2d 32 (Mich. Ct. App. 1996); *People v. Dean*, 497 N.W.2d 223 (Mich. Ct. App. 1993); *People v. Veling*, 504 N.W.2d 456 (Mich. 1993); *Mason v. State*, 868 P.2d 724 (Okla. Crim. App. 1994); see also *State v. Larios*, 874 P.2d 538 (Idaho 1994).

¹⁴⁹ See, e.g., KY. REV. STAT. ANN. § 640.010(3) (Michie 1999 & Supp. 2000); OR. REV. STAT. § 419C.361(1) (1995).

¹⁵⁰ See, e.g., *State v. Mora*, 977 P.2d 564 (Wash. 1999).

¹⁵¹ See, e.g., KAN. STAT. ANN. § 38-1636(i) (1993 & Supp. 1999); OR. REV. STAT. § 419C.361(1) (1995); see also ALASKA STAT. § 47.12.030(a) (Michie 1998); 705 ILL. COMP. STAT. ANN. 405/5-130(1)(b), (2)(b), (3)(b), (4)(b), (5)(b), 405/5-805(5) (West 1999 & Supp. 2000); *Commonwealth v. Solomon*, 679 A.2d 775 (Pa. Super. Ct. 1996). For application of the Illinois statute see *People v. Luckett*, 692 N.E.2d 1345 (Ill. App. Ct. 1998) (stating criminal court properly sentenced juvenile as adult); *People v. A.T.*, 708 N.E.2d 529 (Ill. App. Ct. 1999) (where juvenile's case required mandatory transfer to criminal court, criminal court properly transferred case back to juvenile court for disposition following conviction for nonenumerated offense); *People v. Brown*, 705 N.E.2d 162 (Ill. App. Ct. 1998) (where juvenile's case was transferred to criminal court as a result of discretionary decision, criminal court abused discretion in ruling it lacked discretion to transfer case back to juvenile court for disposition following juvenile's conviction for nonenumerated offense).

A probable cause requirement in criminal court would help assure that the cases that truly ought to be handled in criminal court will, in fact, be handled there, without catching in the same net juveniles who ultimately are convicted, if at all, of some lesser offense that should have been handled in the juvenile court in the first instance. Moreover, a probable cause hearing would serve one of the same purposes as a waiver hearing, namely, that the critical decision whether to treat a juvenile as a juvenile or as an adult will be made at a level of high visibility as opposed to the rather low level of visibility inherent in prosecutorial decision making.¹⁵²

B. Dispositional Alternatives

As in the preceding section, suppose a juvenile, whose case has been transferred to or has originated in criminal court, is charged with, pleads guilty to, or is convicted of a lesser included offense—an offense that would not have qualified the juvenile for adult treatment had it been charged originally. As mentioned previously, some states provide that if the juvenile is convicted of a lesser offense, the case must be remanded to the juvenile court for disposition.¹⁵³ A further option occasionally is available. For example, in Michigan, cases of juveniles fifteen to seventeen years old charged with one of enumerated serious offenses are transferred automatically to criminal court for trial.¹⁵⁴ Following conviction in criminal court, the court has discretion to impose either an adult sentence or a juvenile disposition.¹⁵⁵ Similarly, Oklaho-

¹⁵² See Davis, *supra* note 138, at 741.

¹⁵³ See statutes and cases cited *supra* note 151 and accompanying text.

¹⁵⁴ MICH. COMP. LAWS ANN. § 764.1f (West 2000).

¹⁵⁵ *Id.* § 769.1(3). For application of the Michigan statutory scheme see *People v. Brown*, 517 N.W.2d 806 (Mich. Ct. App. 1994) (proper to sentence two 16-year-old boys convicted of second-degree murder and assault with intent to rob as juveniles); see also *People v. Lyons*, 513 N.W.2d 170 (Mich. Ct. App. 1994) (claiming it was abuse of discretion to sentence 16-year-old boy convicted of first-degree murder as juvenile); *People v. Black*, 513 N.W.2d 152 (Mich. Ct. App. 1994) (holding it was proper to sentence 17-year-old girl convicted of first-degree murder as adult).

ma allows the criminal court to impose either a youthful offender sentence (under supervision of the Office of Juvenile Affairs) or an adult sentence following conviction in criminal court.¹⁵⁶

As a further sentencing or dispositional option available to the juvenile court, some states provide that the court may impose both a juvenile disposition and an adult sentence. For example, Illinois authorizes the court in an "extended jurisdiction juvenile proceeding" to impose a juvenile disposition and also an adult sentence to be stayed on condition that the juvenile successfully complete the juvenile disposition and not commit another offense.¹⁵⁷ Failure to fulfill the conditions will result in revocation of the stay and imposition of the adult sentence.¹⁵⁸ Other states have similar provisions.¹⁵⁹

VII. CONCLUSION

Some safeguards are available to ensure that those cases that ought to be prosecuted in adult court do end up there and that those that ought to be handled as juvenile cases are handled as juvenile cases. Those decisions are best made by judges on a case-by-case basis rather than on the basis of categorical rules such as those discussed above.¹⁶⁰ The decision to be

¹⁵⁶ OKLA. STAT. ANN. tit. 10, §§ 7306-2.8, 7306-2.9 (West 1998 & Supp. 2001). The statutes elsewhere give the criminal court presumptive jurisdiction over "youthful offenders." *Id.* §§ 7306-2.4, -2.6 (West Supp. 2001).

¹⁵⁷ 705 ILL. COMP. STAT. ANN. 405/5-810(4) (West 1999). "Extended jurisdiction juvenile proceeding" is a term common to the Illinois statute and those of other states to designate proceedings involving certain older youths charged with serious offenses. *See infra* note 159.

¹⁵⁸ *Id.*

¹⁵⁹ *See, e.g.*, KAN. STAT. ANN. § 38-16,126(a)-(b) (Supp. 1999); MINN. STAT. ANN. § 260B.130(4) (West Supp. 2001); MONT. CODE ANN. § 41-5-1604(1) (1999). The Montana extended jurisdiction juvenile statute was held unconstitutional on equal protection grounds. *In re S.L.M.*, 951 P.2d 1365 (Mont. 1997).

¹⁶⁰ Reference is to the categorical approaches discussed in Part II of this article, i.e., those rules that exclude certain offenses from the juvenile court's jurisdiction, that authorize concurrent jurisdiction in certain kinds of cases, and that require that cases involving certain offenses originate in criminal court. The preference for judicial discretion over prosecutorial discretion has been urged previously. *See, e.g.*, Davis, *supra* note 138, at 740-41; Samuel M. Davis, *The Jurisdic-*

made, after all, is dispositional in nature, not unlike the sentencing function of judges—on balance, whether the circumstances of the individual case and the individual offender suggest that a juvenile disposition is appropriate or that a more severe sentence available in criminal court seems more appropriate.¹⁶¹ With a discretionary decision-making model in which that decision is made by judges, the only apparent reason for a juvenile's case being handled in criminal court is that dispositions available to the juvenile court are inadequate, given the juvenile's age, the seriousness of the crime, prior record, and the like.¹⁶² Some states already are moving toward the safeguards mentioned above. All of them should be.

tional Dilemma of the Juvenile Court, 51 N.C. L. REV. 195, 231 (1972). Others have advocated the same position. See ZIMRING, *supra* note 2, at 107-09, 125-27.

¹⁶¹ See generally, DAVIS, RIGHTS OF JUVENILES, *supra* note 84, at 2-38 to -39; ZIMRING, *supra* note 2, at 107-29.

¹⁶² See ZIMRING, *supra* note 2, at 107-29.

CHANGE OF CONTROL BOARD: FEDERAL PREEMPTION OF THE LAW GOVERNING A TARGET'S DIRECTORS

Samuel C. Thompson, Jr.

TABLE OF CONTENTS

Abstract	iv
I. Introduction	35
II. Rationale for the Change of Control Board	39
A. Introduction	39
B. Illustration of Conflicts and Current Law	
Governance Rules for Mergers and Acquisitions	40
1. Introduction	40
2. Arm's-length Transactions	41
3. Management Buyouts	44
4. Tender Offer Defensive Tactics	47
5. Freezeout Mergers	56
6. Summary of Current Delaware Corporate Governance Rules for Mergers and Acquisitions	61
7. Economic Effects in the Above Conflicts and in the Merger and Acquisition Market Place Generally	63
C. The ALI's Governance Rules for Mergers and Acquisitions	66
1. Introduction	66
2. Arm's-length Mergers and Acquisitions ...	67
3. Management Buyouts	68
4. Defensive Tactics in Tender Offers	69
5. Freezeouts	71

6. Summary of ALI's Governance Rules for Mergers and Acquisitions	73
7. Comment on the ALI's Approach	76
III. Operation of Change of Control Board	76
A. Introduction	76
B. Corporations Subject to the Rules	76
C. Change of Control Official	79
D. Responsibilities and Authority of Change of Control Board	81
1. In General	81
2. Compensation, Oversight, and Incentive For the Change of Control Board and Its Advisors	86
E. Scope of Authority, Duty of Care, and Business Judgment Rule	88
F. No Personal Liability, Insurance, and Indemnification	91
G. Arbitration of Deadlocks in Majority Control Freezeouts	92
H. Dissolution of the Change of Control Board	92
I. Federal Jurisdiction and Preemption of State Law	93
J. Elimination of Appraisal Remedy	94
K. Effective Date	96
L. Effect on the Williams Act	96
M. Inapplicability of Golden Parachute and Greenmail Provisions of the Internal Revenue Code	98
N. Election-Out	99
O. Regulatory Exemption	100
P. Non-Bona Fide Offers	100
Q. Number of Change of Control Boards That Would Have Been Appointed in 1995 and 1996 and Projection of Future Number of Change of Control Boards	101
IV. Illustration of Application of the Change of Control Board Proposal in Several Seminal Takeover Cases	103
A. Introduction	103

B. Application of Change of Control Concept	104
V. Why Not Use Disinterested Directors Under Existing Law?	108
VI. Why a Federally Mandated Change of Control Board	117
A. Introduction	117
B. Comparison of This Proposal With Federalization Proposals of Professor Cary and Others	119
C. Criticisms of the Cary Approach	121
1. The Basic Criticism	121
2. The Empirical Support for the Criticism	122
3. The Empirical Support for the Cary Position	125
4. Summary	132
VII. Survey of Other Proposals for Addressing Change of Control Transactions and Comparison With Change of Control Board	134
A. Survey	134
B. Comparison of Other Proposals With the Change of Control Board Concept	140
VIII. Comparison of Change of Control Board Concept With Rules Governing a Target's Directors, in the United Kingdom, Germany, and the European Union	141
IX. Analysis of Negative Comments of Several Merger and Acquisition Practitioners	145
X. Conclusion	150
Appendix	153

CHANGE OF CONTROL BOARD: FEDERAL PREEMPTION OF THE LAW GOVERNING A TARGET'S DIRECTORS

ABSTRACT

This article sets out a proposed federal uniform standard governing the actions by the board of directors of a publicly held corporation that is the target of a change of control transaction. This proposal would apply in each of the following four merger and acquisition transactions: (1) the acquisition of a target in an arm's-length negotiated merger or acquisition; (2) the acquisition of a target in a management buyout; (3) the proposed acquisition of a target in a hostile tender offer; and (4) the acquisition by a target's controlling shareholder of the minority interests in such target in a freezeout merger.

Under this proposal, an independent and knowledgeable change of control board would be appointed for the target, and this board would have complete authority over the acquisition process. Because of the board's obvious independence, a uniform governance standard, the business judgment rule, would apply in determining if the board acted properly.

This article proposes that federal law preempt state law rules governing the actions of a publicly held target's board in each of these transactions. However, this is only a default rule because a corporation's shareholders could elect not to have the provision apply or could elect to have it apply only in certain circumstances, such as in a hostile tender offer. The adoption of this provision would enhance the competition for corporate governance rules in change of control transactions.

This proposal would replace the four separate governance rules generally applicable to a target's directors under Delaware and other state law in arm's-length transactions, management buyouts, tender offers, and freezeouts. This article

also rejects the four sets of rules proposed for these transactions in the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendation*.

This proposal would also override all state takeover laws, such as control share statutes, business combination statutes and disgorgement statutes, which generally have the purpose or effect of protecting incumbent management.

By placing the control of the change of control process in the hands of truly disinterested directors and applying the business judgment rule in all cases in which a change of control board acts, this proposal should cure the problem of unpredictability and vagueness, should result in a substantial decrease in litigation in change of control situations, and should enhance the efficiency of the change of control market.

CHANGE OF CONTROL BOARD: FEDERAL PREEMPTION OF THE LAW GOVERNING A TARGET'S DIRECTORS

*Samuel C. Thompson, Jr.**

I. INTRODUCTION

This article sets out a proposed federal uniform standard governing the actions by the board of directors of a publicly-

* Professor and Director, Center for the Study of Mergers and Acquisitions, University of Miami School of Law. First, I would like to thank the members of the University of Miami faculty who participated in the 1995 faculty symposium at which I first presented this paper. This paper reflects comments made by the following faculty members: Anthony Alfieri, Tim Canova, Mary Coombs, John Gaubatz, Steve Halpert, Elliott Manning and Tom Robinson. Second, I would like to thank Professor Roberta Romano of the Yale Law School for her extensive comments and for arranging for me to present this paper at the Law, Economics and Organization Workshop at Yale during the fall semester 1998. Comments from the following participants in that workshop were particularly helpful: Susan Rose-Ackerman, Ian Ayres, Josh Brady, Henry Hansmann, Ian Lopez, John Langbein, Roberta Romano, and Alan Schwartz. Third, I thank the following merger and acquisition practitioners for their critiques: R. Franklin Balotti of Richards, Layton & Finger; Dennis S. Hersch, head of the mergers and acquisitions department at Davis Polk and Wardwell; Marshall L. Small of Morrison & Forester LLP, one of the reporters on the American Law Institute Corporate Governance Project; and Martin Lipton of Wachtell, Lipton, Rosen & Katz. Fourth, I want to thank the members of the University of Virginia Law School faculty who participated in a 2001 faculty symposium on this paper. Various sections of this paper reflect comments by the following Virginia faculty members: Ed Kitch, Kevin Kordana, Mike Dooley, Paul Stephan, Bob Scott, Paul Mahoney and George Cohen. Fifth, I thank the faculty of the Washington and Lee University School of Law for their helpful workshop in 2001 on this paper; comments from the following W&L faculty members are reflected here: Lyman Johnson, David Millon, Leo J. O'Brien, and Mark Grunewald. I must emphasize that very few of the comments were supportive of the concept proposed here. Finally, thanks to my research assistants, Sholanda Wright and Gheri Hicks, both graduates of the University of Miami School of Law and to my wife, Barbara Gothard Thompson, who participated in two of the workshops.

held corporation that is the target of a change of control board transaction. This proposal would apply in each of the following four merger and acquisition transactions:

- (1) The acquisition of a target in an arm's-length negotiated merger or acquisition;
- (2) The acquisition of a target in a management buyout;
- (3) The proposed acquisition of a target in a hostile tender offer; and
- (4) The acquisition by a target's controlling shareholder of the minority interests in such target in a freezeout merger.

Under this proposal, an independent and knowledgeable change of control board would be appointed for the target,¹ and this board would have complete authority over the acquisition process. Because of the board's obvious independence, one uniform governance standard, the business judgment rule, would apply in determining if the board acted properly.

This article proposes that federal law preempt state law rules governing the actions of a publicly-held target's board in each of these transactions. However, this is only a default rule because a corporation's shareholders could elect not to have the provision apply or could elect to have it apply only in certain circumstances, such as in a hostile tender offer. The adoption of this provision would, therefore, enhance the competition for corporate governance rules in change of control transactions.

This proposal would replace the four separate governance rules generally applicable to a target's directors under Delaware and other state law in arm's-length transactions, management buyouts, tender offers, and freezeouts. This article

¹ This article does not address the issue of the proper treatment of the acquiring corporation, unless the target's shareholders after the acquisition end up with more than 50% of the acquiror stock. See *infra* Part III.B. Several proposals exist for the treatment of the acquiror. See John R. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1269-72 (1984) (suggesting that acquiror's shareholders have right to vote on acquisitions above certain size); George W. Dent, Jr., *Unprofitable Mergers: Toward a Market Based Legal Response*, 80 NW. U. L. REV. 777, 794-806 (1986) (proposing that courts enjoin acquisitions where announcement of which causes material decline in price of acquiror's stock).

also rejects the four sets of rules proposed for these transactions in the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendation*.² However, the scope of authority of a change of control board, the duty of care governing the actions of a change of control board, and the formulation of the business judgment rule protection for a change of control board are based on analogous provisions of the ALI's Corporate Governance Project.

This proposal would also override state takeover laws, such as control share statutes, business combination statutes, and disorgorgement statutes, which generally have the purpose or effect of protecting incumbent management.

In a recent article, Professors Bebchuck and Ferrell of Harvard Law School stated the following:

Our analysis of Delaware takeover law highlights the fact that its rules governing defensive tactics seem to be characterized by unnecessary ambiguity and unpredictability, resulting in frequent litigation. While this aspect of Delaware law benefits the interest of the Delaware bar, which might be of importance to Delaware, it is difficult to see how shareholders are benefited by the excessive unpredictability and vagueness of its rules.³

Since the corporate governance rules proposed by the ALI are similar to those in Delaware, it could be expected that the adoption of the ALI rules would not solve this problem of unpredictability and vagueness. On the other hand, by placing the control of the change of control process in the hands of truly disinterested and informed directors and applying the business judgment rule in all cases in which a change of control board acts, this proposal should cure the problem of unpredictability

² AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATION* (vols. 1 and 2) (1994) [hereinafter *CORPORATE GOVERNANCE PROJECT*]. The ALI's approach to these four transactions is explored in detail in Samuel C. Thompson, Jr., *The Merger and Acquisition Provisions of the ALI Corporate Governance Project As Applied to the Three Steps in the Time-Warner Acquisition*, 1996 COLUM. BUS. L. REV. 145 (1996).

³ Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1172 (1999).

and vagueness, should result in a substantial decrease in litigation in change of control situations, and should enhance the efficiency of the change of control market.

I must emphasize that this article is not an attack on the Delaware judiciary or bar; as a teacher of corporate law, I believe that Delaware has the most knowledgeable corporate law judges and many of the most knowledgeable corporate lawyers in the country. Adoption of this proposal would only reduce the role of the Delaware bench and bar in change of control transactions; they would continue to be active in other areas of corporate law.

While most readers of this article will likely have an initial adverse reaction to the idea of federalizing any aspect of state corporate law, the purpose and effect of this proposal is to reduce regulatory and judicial interference in the market for corporate control. Thus, both those who believe the current federal system produces a "race to the bottom" and those who believe the system produces a "climb to the top" should support this proposal.

Section II of this article sets out the rationale for the change of control board concept by illustrating the conflicts of interest existing under current law and showing how this proposal would remedy these conflicts and provide other benefits. This section also reviews the proposals in the ALI Corporate Governance Project for the treatment of change of control transactions and discusses why these proposals are not an adequate substitute for the change of control board concept.

Section III discusses in detail the operation of the change of control board concept and outlines the collateral changes to the federal securities laws that would be needed if the change of control concept were adopted. To facilitate analysis of this proposal, the Appendix contains a suggested amendment (*i.e.*, Proposed Section 14A) to the Securities Exchange Act of 1934 (the "1934 Act") detailing the operation of the change of control board concept.

Section IV illustrates how the change of control board concept would have applied in several leading cases. Section V then discusses why the use of the current concept of disinter-

ested directors does not effectively address the fundamental conflict problem in change of control situations.

Section VI examines whether a federal uniform governance standard is consistent with the empirical evidence bearing on the advisability of federalizing corporate law. Section VII surveys various other proposals for addressing change of control transactions, and Section VIII compares the change of control board concept with the rules governing takeovers in the United Kingdom, Germany, and the European Union. Section IX analyzes the negative comments of several merger and acquisition practitioners on this proposal, and finally, Section X, the conclusion, provides a summary of the arguments in support of the adoption of the change of control concept.

II. RATIONALE FOR THE CHANGE OF CONTROL BOARD

A. Introduction

The basic purpose of the change of control board is to eliminate the potential conflict of interest facing a target's board in each of the four acquisition transactions mentioned above. Potential conflict is apparent and well recognized in management buyouts, tender offers, and freezeouts.

The potential conflicts also exist in arm's-length transactions, because the target's board or senior managers may receive in connection with such a merger or acquisition a collateral payment, such as a golden parachute payment or a post-acquisition employment agreement. Deutsche Bank AG's acquisition of Bankers Trust Corporation in an arm's-length transaction provides a good illustration of these potential conflicts. The merger agreement provided for substantial annual payments to several of the top officials of Bankers Trust, including a \$10.1 million annual bonus to the Chairman and Chief Executive Officer, Frank Newman.⁴ Shortly after completion of the transaction, Mr. Newman resigned "with a controversial \$69 million pay package after failing to land a spot on Deutsche Bank's board and after reports that Bankers Trust

⁴ Bankers Trust Corp., PROXY STATEMENT, 38 (Mar. 23, 1999).

used unclaimed customer funds to pump up its bottom line."⁵ It is highly likely that Mr. Newman would not have received payments at these levels if a change of control board had been in place for Bankers Trust. On the other hand, nothing here would limit the post merger compensation an acquiror could pay the target's top management.

The discussion below illustrates the conflicts in several leading change of control cases and shows how the current corporate governance rules address these issues. Also, the rules for change of control transactions proposed in the ALI Corporate Governance Project are examined. Neither the current rules nor the rules proposed in the Project adequately address these transactions.

B. Illustration of Conflicts and Current Law Governance Rules for Mergers and Acquisitions

1. Introduction

This section examines several seminal cases that illustrate the potential conflicts in arm's length, management buyout, tender offer, and freezeout transactions. The section below dealing with arm's length transactions considers the Delaware Supreme Court's decisions in (1) *Smith v. Van Gorkom*,⁶ (2) *Paramount Communications, Inc. v. Time, Inc. (Time-Warner)*,⁷ and (3) *Paramount Communications, Inc. v. QVC Network, Inc. (QVC)*.⁸ Although *Time-Warner* and *QVC* resulted in hostile tender offers, they started as arm's-length negotiated transactions.⁹

The section which addresses management buyouts looks at the Second Circuit's 1986 decision in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*¹⁰ and the Delaware Chancery Court's 1996 decision in *Kahn v. Dairy Mart Convenience Stores, Inc.*¹¹

⁵ Karen Lowry Miller et al., *Fixing Deutsche Bank*, BUS. WK., July 19, 1999, at 56, 56.

⁶ 488 A.2d 858 (Del. 1985).

⁷ 571 A.2d 1140 (Del. 1989).

⁸ 637 A.2d 34 (Del. 1993).

⁹ *Time-Warner*, 571 A.2d at 1143-46; *QVC*, 637 A.2d at 39-40.

¹⁰ 781 F.2d 264 (2d Cir. 1986).

¹¹ Civ. A. No. 12489, 1996 WL 159628 (Del. Ch. Mar. 29, 1996), 21 DEL. J.

In considering tender offers, the Delaware Supreme Court's decisions in (1) *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,¹² (2) *Time-Warner*, and (3) *QVC* are examined. This section also examines a Delaware federal district court's decision under Delaware law in *Moore Corp. v. Wallace Computer Services, Inc.*¹³ and the Pennsylvania federal district court's decision under Pennsylvania law in *Norfolk Southern Corp. v. Conrail, Inc.*¹⁴ In addition, this section discusses the Delaware standard governing the actions of a target's directors in a tender offer as reflected in *Unocal Corp. v. Mesa Petroleum Co.*¹⁵ and *Unitrin, Inc. v. American General Corp.*¹⁶

The section focusing on freezeouts examines the Delaware Supreme Court's decisions in *Weinberger v. UOP, Inc.*¹⁷ and *Kahn v. Lynch Communication Systems, Inc.*¹⁸

These decisions are briefly summarized below. Although many other cases could be discussed, these cases illustrate the conflicts that can arise in the four types of change of control transactions addressed here. Section IV discusses the manner in which the change of control board proposal would have applied in each of these cases.

2. Arm's-length Transactions

*Smith v. Van Gorkom*¹⁹ was an arm's-length acquisition in which Trans Union, a publicly-held corporation, was acquired in a cash merger by Marmon, a corporation controlled by the Pritzker family.²⁰ The chief executive officer of Trans Union, Van Gorkom, was the driving force behind the transaction.²¹ He was a major shareholder of Trans Union and was about to

CORP. L. 1143 (1996).

¹² 506 A.2d 173 (Del. 1986).

¹³ 907 F. Supp. 1545 (D. Del. 1995)

¹⁴ No. 96-7167, 1997 U.S. Dist. LEXIS 978 (E.D. Pa. Jan. 9, 1997).

¹⁵ 493 A.2d 946 (Del. 1985).

¹⁶ 651 A.2d 1361 (Del. 1995).

¹⁷ 457 A.2d 701 (Del. 1983).

¹⁸ 638 A.2d 1110 (Del. 1994), *on remand*, No. 8749, 1995 WL 301403 (Del. Ch. Apr. 17, 1995), *aff'd*, 669 A.2d 79 (Del. 1995).

¹⁹ 488 A.2d 858 (Del. 1985).

²⁰ *Van Gorkom*, 488 A.2d at 865-70.

²¹ *Id.* at 865-66.

reach retirement age.²² After consulting with Trans Union's controller concerning an acceptable acquisition price for Trans Union, but without consulting Trans Union's investment banker, Van Gorkom suggested to Jay Pritzker that Marmon acquire Trans Union at a price of \$55 per share.²³ This price was a substantial premium over the market price of the Trans Union shares.²⁴ Jay quickly accepted the offer but demanded a lock-up option to purchase a substantial number of Trans Union shares at \$.75 above market.²⁵ He also demanded that Trans Union not shop the deal.²⁶ Van Gorkom accepted both terms.²⁷ Over the objection of some members of senior management, Trans Union's Board approved the transaction at a hastily-called two-hour meeting.²⁸

The Delaware Supreme Court noted that since Van Gorkom was approaching retirement age, he may have been particularly motivated to effectuate a quick sale of the company and of his shares.²⁹ Notwithstanding this potential conflict, the court did not find that Van Gorkom had a legally cognizable conflict of interest sufficient to take the transaction out of the business judgment rule.

The board consisted of a majority of outside directors who were found by the court to be sophisticated, experienced in business affairs, and well informed about Trans Union's finances.³⁰ The court held, however, that the directors "did not adequately inform themselves as to Van Gorkom's role in forcing the 'sale' of the Company . . . [and] were grossly negligent in approving the 'sale' . . . upon two hours consideration"³¹ The court, therefore, denied the directors the

²² *Id.* at 866.

²³ *Id.*

²⁴ *Id.* at 869 n.9.

²⁵ *Van Gorkom*, 488 A.2d at 866.

²⁶ *Id.* at 868.

²⁷ *Id.* at 867.

²⁸ *Id.* at 869.

²⁹ *Id.* at 866.

³⁰ *Van Gorkom*, 488 A.2d at 868.

³¹ *Id.* at 874.

protection of the business judgment rule and remanded for a determination of damages.³²

A quick reading of the facts of the *Van Gorkom* case leads one to ask why a sophisticated executive like Van Gorkom would follow such a casual procedure in selling an undervalued public corporation. One might argue Van Gorkom was motivated by something other than a desire to maximize the long-term interest of the shareholders. This is so even though Van Gorkom was a major shareholder himself. It may have been that he was interested most in maximizing what he perceived to be his own short term interest by effectuating a quick sale while he was still in control of the corporation.

In criticizing the court's decision, Professor Fischel argues:

Van Gorkom had strong incentives to negotiate the best deal possible. The transaction was negotiated at arm's-length; moreover, Van Gorkom was himself a large shareholder. The better the deal that Van Gorkom negotiated, the more money he made himself. . . . Van Gorkom was one year away from retirement and thus had no reason to block a merger in the interest of keeping his job.³³

While all of these points are true, they do not contradict the observation that Van Gorkom presumably had a personal interest in seeing a quick sale of the company and that he may have let his personal interest lead him to an unwise decision to sell.

The *Van Gorkom* decision also illustrates that independent directors are not necessarily reliable as a check on strong insiders like Van Gorkom. The adoption of the change of control board concept proposed here would eliminate the potential for a strong chief executive to dominate a target's decision-making process in a change of control situation. Although the change of control board would be expected to consult with the corporation's senior managers and its board, it is highly unlikely that the control board would permit itself to be dominated.

³² *Id.* at 893.

³³ Daniel R. Fischel, *The Business Judgment Rule and The Trans Union Case*, 40 BUS. LAW. 1437, 1445-46 (1985).

In both the *Time-Warner* and *QVC* transactions, which are examined in more detail below in connection with tender offers, the boards of corporations that ultimately became the targets of hostile tender offers (*i.e.*, Time and Paramount) negotiated arm's-length merger agreements with friendly corporations.³⁴ The boards of both these companies had a majority of independent directors.³⁵ Both merger agreements contained provisions designed to discourage third party bids, and, at the time the merger agreements were entered into, the boards of both Time and Paramount knew that other firms were interested in acquiring them.³⁶ It is inconceivable that a change of control board would have entered into either of these "arm's-length" transactions without first thoroughly exploring other potential transactions.

3. Management Buyouts

In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,³⁷ Hanson made a tender offer for SCM, and in response, several of SCM's inside directors, together with Merrill Lynch, proposed a leveraged management buyout as an alternative to Hanson's offer.³⁸ In evaluating the two offers, SCM's board acted through a committee of disinterested directors who were advised by the investment banking firm of Goldman Sachs and the law firm of Wachtell Lipton.³⁹

On the advice of Goldman and Wachtell, the disinterested directors granted a crown jewel lock-up option to the management group.⁴⁰ At this point, the offer of the management group was for cash and stock with an aggregate estimated value of \$72.50 per share, and Hanson's offer was for cash of \$72 per share.⁴¹ Hanson subsequently increased its offer to

³⁴ *Time-Warner*, 571 A.2d 1140, 1143 (Del. 1989); *QVC*, 637 A.2d 34, 34 (Del. 1993).

³⁵ *Time-Warner*, 571 A.2d at 1143; *QVC*, 637 A.2d at 34.

³⁶ *Time-Warner*, 571 A.2d at 1144-46; *QVC*, 637 A.2d at 39-40.

³⁷ 781 F.2d 264 (2d Cir. 1986).

³⁸ *Hanson Trust*, 781 F.2d at 268-69.

³⁹ *Id.* at 267-68.

⁴⁰ *Id.* at 270.

⁴¹ *Id.* at 271.

\$75 per share in cash.⁴² In addition to the lock-up option, SCM also granted the management group a no-shop agreement and paid Merrill Lynch's fees for entering the bidding ("hello fees") and agreed to pay Merrill a fee in the event its offer failed (a "goodbye fee").⁴³

Although Goldman Sachs advised the disinterested directors that the option prices were within the range of fair value, the court found that the option prices were substantially undervalued and that "the disinterested directors never asked Goldman what the stock would generate at top value."⁴⁴

The Second Circuit Court of Appeals, applying New York law, observed that it appeared as if Goldman, Wachtell, and the disinterested directors wanted the management group to prevail.⁴⁵ The court nevertheless found that the disinterested directors were not interested in the transaction and acted in good faith and without fraud, which are the normal conditions for protection under the business judgment rule.⁴⁶ The court went on to say, however, that this was not enough and that the directors were required to meet the "standard of due care" with "conscientious fairness."⁴⁷ The court elaborated on this point as follows:

The law is settled that, particularly where directors make decisions likely to affect shareholder welfare, the duty of due care requires that a director's decision be made on the basis of 'reasonable diligence' in gathering and considering material information. In short, a director's decision must be an informed one.⁴⁸

In support of this proposition the court cited a draft of the ALI Corporate Governance Project.⁴⁹

⁴² *Id.* at 272.

⁴³ *Hanson Trust*, 781 F.2d at 270.

⁴⁴ *Id.* at 275.

⁴⁵ *Id.* at 272-73.

⁴⁶ *Id.* at 274.

⁴⁷ *Id.*

⁴⁸ *Hanson Trust*, 781 F.2d at 274.

⁴⁹ *Id.*

The court went on to find that although the actions of the disinterested directors did not amount to gross negligence as in *Van Gorkom*, the disinterested directors did not properly inform themselves of the value of the optioned assets.⁵⁰ Consequently, their actions were not protected by the business judgment rule.⁵¹ The burden, therefore, switched to the disinterested directors to prove that the option price was either fair or in the interest of the shareholders, and the directors failed to meet this burden.⁵² The option was, therefore, enjoined.⁵³

*Kahn v. Dairy Mart Convenience Stores, Inc.*⁵⁴ applies Delaware law in a management buyout in which the target was to be acquired by an entity controlled by the target's controlling shareholder.⁵⁵ In such case, the entire fairness test applies.⁵⁶ Further, under *Lynch*, which is discussed below in connection with freezeouts, the burden of proof is on the defendant to establish that the transaction is entirely fair, unless there is a "properly functioning committee of independent directors representing the interest of the minority"⁵⁷ In such a case, the burden shifts to the plaintiff.⁵⁸ In *Dairy Mart*, the court said that it could not find as a matter of law that the independent committee functioned properly.⁵⁹ One of the two members of the committee was a paid consultant to the target, and the committee did not attempt to negotiate a higher price than that offered by the management group because the controlling shareholder would not permit the target to consider any other offers.⁶⁰ Also, the court pointed out that in this situation, "the selection of professional advisors for the committee doesn't give

⁵⁰ *Id.* at 275.

⁵¹ *Id.*

⁵² *Id.* at 277-83.

⁵³ *Hanson Trust*, 781 F.2d at 283.

⁵⁴ No. 12489, 1996 WL 159628 (Del. Ch. Mar. 29, 1996), 21 DEL. J. CORP. L. 1143 (1996).

⁵⁵ *Dairy Mart*, 1996 WL at *1, 21 DEL. J. CORP. L. at 1149-50.

⁵⁶ *Id.* at *8, 21 DEL. J. CORP. L. at 1156.

⁵⁷ *Id.* at *6, 21 DEL. J. CORP. L. at 1156.

⁵⁸ *Id.*

⁵⁹ *Id.* at *7-8, 21 DEL. J. CORP. L. at 1157.

⁶⁰ *Dairy Mart*, 1996 WL at *7-8, 21 DEL. J. CORP. L. at 1157-58.

comfort, it raises questions.”⁶¹ Finding that it could not conclude as a matter of law that the transaction was entirely fair, the court denied the defendant’s motion for summary judgment.⁶²

Under Delaware law, if it is clear that the independent directors are the decision-makers for the target, and these directors are not in any way related to the buyout group, the business judgment rule may apply.⁶³

Hanson Trust shows that even though disinterested directors may not have a legally cognizable interest in a transaction, they may have a bias for management that deters their ability to act vigorously in promoting the welfare of shareholders. It is highly unlikely that any change of control board would conduct itself like the boards in *Hanson Trust* or in *Dairy Mart*. Also, the legal and other advisors to the change of control board would not be beholden to the senior management, as was apparently the case in *Hanson Trust*.

4. Tender Offer Defensive Tactics

*Revlon v. MacAndrews & Forbes Holdings, Inc.*⁶⁴ involved a battle for control of Revlon between Pantry Pride and Forstmann Little, which acted as a “white knight” in coming to the rescue of Revlon.⁶⁵ The board of Revlon granted an auction ending lock-up to Forstmann, which Revlon favored throughout the process, even though Forstmann’s offer was not clearly superior to Pantry Pride’s offer.⁶⁶ As part of its offer, Forstmann agreed to support the value of Revlon’s outstanding notes, which had been issued by Revlon as a defensive tactic in exchange for part of its outstanding stock.⁶⁷

In setting out the legal standard to be applied in the case, the Delaware Supreme Court first noted that under the busi-

⁶¹ *Id.* at *8 n.6, 21 DEL. J. CORP. L. at 1158 n.6.

⁶² *Id.* at *10, 21 DEL. J. CORP. L. at 1161.

⁶³ *In re RJR Nabisco, Inc. Shareholders’ Litigation*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. Jan. 31, 1989).

⁶⁴ 506 A.2d 173 (Del. 1986).

⁶⁵ *Revlon*, 506 A.2d at 176, 183.

⁶⁶ *Id.* at 175-79.

⁶⁷ *Id.* at 178-79.

ness judgment rule, the directors get the benefit of a presumption that in making a decision they acted: (1) on an informed basis, (2) in good faith, and (3) in the honest belief that the action taken was in the best interest of the corporation.⁶⁸ The court noted that this rule did not apply here, because in this situation the enhanced duty adopted by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.* applies.⁶⁹ The *Unocal* court noted that when a board adopts takeover defenses there arises "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders"⁷⁰ If directors act in their own self-interest, the business judgment rule does not apply, because disinterestedness is one of the conditions for application of the rule.⁷¹ The *Revlon* court went on to set out the *Unocal* enhanced standard as follows:

This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation. In addition, the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance — that the responsive action taken is reasonable in relation to the threat posed.⁷²

Thus, as a result of the potential conflict of interest inherent in the adoption of takeover defenses, the *Revlon* directors had the burden of proving first that they acted in good faith and conducted a reasonable investigation.⁷³ Proof of these elements would show reasonable grounds for believing there was a danger to corporate policy and effectiveness.⁷⁴ The directors

⁶⁸ *Id.* at 180 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (1984)).

⁶⁹ *Id.* (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)).

⁷⁰ *Unocal*, 493 A.2d at 954.

⁷¹ *Revlon*, 506 A.2d at 180.

⁷² *Id.* (citations omitted).

⁷³ *Id.*

⁷⁴ *Id.*

then had to show that their defensive measures were reasonable in relation to the threat posed.⁷⁵

In addressing the issue of whether there was a threat to Revlon's corporate policy and effectiveness, the court reasoned as follows: at the point in the bidding war that it became apparent that the break-up of Revlon was imminent, the "duty of the board changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."⁷⁶ At this point, "the question of defensive measures became moot, [and] [t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."⁷⁷

In applying this legal standard, the court found that the "principal object" of the Revlon board in granting the lock-up option "appears to have been protection of the noteholders over the shareholders' interest."⁷⁸ The board was concerned that if Pantry Pride's offer succeeded, the notes would lose value and the directors could be held personally liable.⁷⁹

The court reasoned that although lock-ups and related agreements are permitted when not tainted by director interest and other breaches of fiduciary duty, the actions taken by the Revlon directors did not satisfy this disinterested standard.⁸⁰ Further, citing *Unocal*, the court said that a "board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."⁸¹

Further, the court stated that the noteholders had accepted the notes subject to fixed contractual terms and, therefore, "nothing remained for Revlon to legitimately protect, and no rationally related benefit thereby accrued to the stockhold-

⁷⁵ *Id.*

⁷⁶ *Revlon*, 506 A.2d at 182.

⁷⁷ *Id.*

⁷⁸ *Id.* at 184.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Revlon*, 506 A.2d at 182.

ers."⁸² Consequently, "the merger agreement with Forstmann was unreasonable in relation to the threat posed," and, therefore, the court enjoined the merger, the no-shop agreement, and the payment of cancellation fees.⁸³

Revlon demonstrates that although a target's board may not have a legally cognizable interest in the acquiring vehicle, it may have other reasons for favoring one party to a takeover at the expense of the shareholders. In this regard the court noted:

Revlon had dealt preferentially, and almost exclusively, with Forstmann throughout the contest. After the directors authorized management to negotiate with other parties, Forstmann was given every negotiating advantage that Pantry Pride had been denied: cooperation from management, access to financial data, and the exclusive opportunity to present merger proposals directly to the board of directors . . . [T]he directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions.⁸⁴

In elaborating on the second prong of the *Unocal* test—that the defensive measures be balanced—the Delaware Supreme Court in *Unitrin, Inc. v. American General Corp.*⁸⁵ held that a defensive action could not be coercive or preclusive and must fall within a range of reasonableness.⁸⁶ At a minimum, the actions of Revlon's board would appear to be preclusive.

The adoption of the change of control board concept would avoid the type of favoritism shown by Revlon's board for the Forstmann offer. It can be expected that a change of control board would be fiercely loyal and diligent in pursuing the welfare of the target's shareholders.

In *Time-Warner*, Time and Warner agreed to a stock for stock merger in which Time would acquire Warner in a reverse subsidiary merger, with the Warner shareholders owning 62%

⁸² *Id.* at 182-83.

⁸³ *Id.* at 183-204.

⁸⁴ *Id.* at 184.

⁸⁵ 651 A.2d 1361 (Del. 1995).

⁸⁶ *Unitrin*, 651 A.2d at 1387-88.

of the resulting company, Time-Warner.⁸⁷ The merger agreement contained certain defensive measures such as a "no-shop," and Time had a poison pill in place.⁸⁸ Delaware law provided that Warner's shareholders had to approve the merger, and the New York Stock Exchange (NYSE) rules provided that Time's shareholders had to approve the transaction.⁸⁹

After Time and Warner mailed their proxy material, Paramount made an "all cash, all shares" tender offer for Time at \$175 per share.⁹⁰ Time's board found this offer inadequate and restructured its acquisition with Warner as a two-step transaction as follows: first, a cash tender offer for 51% of Warner's shares at \$70 per share; second, a freezeout merger for Time-Warner securities also at \$70 per share.⁹¹ Paramount increased its tender offer for Time to \$200 per share, but Time's board also rejected this offer as inadequate.⁹² As pointed out by Chancellor Allen in the lower court opinion, Time's investment banker, Wasserstein Perella, rendered an opinion that Time was worth substantially more than \$200 per share.⁹³ In commenting on Wasserstein's prediction that the trading range for Time's shares in 1993 would be between \$208 and \$402, Chancellor Allen said that this is a "range that a Texan might feel at home on."⁹⁴

Certain shareholder plaintiffs brought action against Time arguing that under *Revlon*, Time was required to auction itself because by entering into the transaction with Warner and adopting the protective devices, Time had put itself in play.⁹⁵ Paramount and the shareholder plaintiffs also brought a *Unocal* claim against Time's board.⁹⁶

⁸⁷ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1146 (Del. 1989).

⁸⁸ *Time-Warner*, 571 A.2d at 1146.

⁸⁹ *Id.*

⁹⁰ *Id.* at 1147.

⁹¹ *Id.* at 1148.

⁹² *Id.* at 1149.

⁹³ *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Recp. (CCH) ¶ 94,514 at 93,272-73 (Del. Ch. July 14, 1989).

⁹⁴ *Id.*

⁹⁵ *Time-Warner*, 571 A.2d at 1149.

⁹⁶ *Id.*

The court first held that Time's board acted on an informed basis in negotiating the original merger, and consequently, this transaction was protected by the business judgment rule.⁹⁷

Second, the court held that even though the Time shareholders would have become minority shareholders of Time-Warner, there was no change of control of Time because the stock of Time-Warner would be in the hands of a "fluid aggregation of unaffiliated shareholders."⁹⁸ Consequently, Time had not put itself up for sale, and the *Revlon* auction requirement was not applicable.⁹⁹

Third, the court held that in structuring the tender offer for Warner, Time initiated a defensive tactic that was governed by *Unocal*.¹⁰⁰ Under the first part of the *Unocal* test, Time correctly concluded that Paramount's offer posed a "cognizable threat" to Time's "culture."¹⁰¹ Under the second part of the *Unocal* standard, the Court found Time's tender offer for Warner to be reasonable in relation to the threat posed.¹⁰² Thus, the court let Time reject Paramount's offer and proceed with its transaction with Warner.¹⁰³

In *QVC*,¹⁰⁴ after several discussions, Paramount and Viacom entered into a merger agreement pursuant to which Viacom, which was controlled by Sumner Redstone, would acquire Paramount.¹⁰⁵ The consideration originally to be paid by Viacom was Class A voting stock, Class B non-voting stock and \$9.10 in cash, with an aggregate value of approximately \$70 per share of Paramount.¹⁰⁶ The merger had (1) a no shop, (2) a termination fee of \$100 million, and (3) a stock option on 19.9% of Paramount's stock.¹⁰⁷ The stock option could be paid for by Viacom's subordinated note, and as an alternative to

⁹⁷ *Id.* at 1150.

⁹⁸ *Id.* at 1150.

⁹⁹ *Id.* at 1151.

¹⁰⁰ *Time-Warner*, 571 A.2d at 1151.

¹⁰¹ *Id.* at 1153.

¹⁰² *Id.* at 1155.

¹⁰³ *Id.*

¹⁰⁴ 637 A.2d 34 (Del. 1993).

¹⁰⁵ *QVC*, 637 A.2d at 39.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

exercising of the option, Viacom could "put" the option to Paramount for the bargain element inherent in the option.¹⁰⁸ Also, Paramount had a poison pill, and Paramount's CEO was to continue to run Paramount.¹⁰⁹

"Paramount wanted at least \$70 per share."¹¹⁰ QVC countered with a proposed merger for cash and stock at \$80 per share.¹¹¹ Paramount's board of directors refused to negotiate with QVC because of an unsatisfied financing condition.¹¹²

QVC later made a tender offer for 51% of Paramount's stock to be followed by a second step merger for common stock of QVC.¹¹³ At this point, QVC's bid was \$10 higher than Viacom's merger consideration.¹¹⁴

Viacom and Paramount then renegotiated their deal as a tender offer by Viacom for 51% of Paramount's stock to be followed by a second step merger for Viacom stock with a price of \$80 per share at both stages.¹¹⁵

QVC's proposed fair bidding process was rejected, and Viacom and Paramount amended Viacom's tender offer to \$85 in cash with \$85 in stock in the second step merger.¹¹⁶ QVC then amended its bid to \$90 in cash with \$90 in stock on the back end.¹¹⁷

These offers can be summarized as follows:

(1) Viacom	→	\$70
(2) QVC	→	\$80
(3) Viacom	→	\$80
(4) Viacom	→	\$85
(5) QVC	→	\$90

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *QVC*, 738 A.2d at 39.

¹¹¹ *Id.*

¹¹² *Id.* at 40.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *QVC*, 637 A.2d at 40.

¹¹⁶ *Id.* at 41.

¹¹⁷ *Id.*

Paramount's board of directors determined that QVC's \$90 offer was not in the best interests of the corporation.¹¹⁸ Also, Paramount's board of directors did not negotiate with QVC because of the unsatisfied financing contingency.¹¹⁹

The court first noted there are rare cases in which a court will "take a more direct and active role in overseeing" a board's decisions.¹²⁰ In such cases the court subjects the directors to "enhanced scrutiny" to ensure reasonableness citing, *inter alia*, *Unocal* and *Revlon*.¹²¹ The court said that this case raises two situations that implicate enhanced scrutiny: (1) a sale of control and (2) defensive measures.¹²²

There was a sale of control because Sumner Redstone was in control of Viacom and would become the controlling shareholder of Paramount.¹²³ This is distinguished from *Time-Warner*, where the stock of Time after the acquisition would be held by a "fluid aggregation of unaffiliated shareholders representing a voting majority."¹²⁴ Paramount's shareholders were entitled to a control premium, and, in the absence of such a premium, the directors had an obligation to get the shareholders the "best value reasonably available" (BVRA).¹²⁵ Thus, in a sale of control situation, enhanced scrutiny applies.¹²⁶

The court reasoned that where directors take action to cause a change of control or to break-up the target, they have an obligation to seek the BVRA.¹²⁷ Thus, *Time-Warner* is not controlling in such a situation.¹²⁸ The court went on to state that "[t]he Paramount Board, albeit unintentionally, had 'initiate[d] an active bidding process seeking to sell itself' by agreeing to sell control of the corporation to Viacom in circumstances where another potential acquiror (QVC) was equally

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *QVC*, 637 A.2d at 42.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.* at 43.

¹²⁴ *Time-Warner*, 571 A.2d at 1150.

¹²⁵ *QVC*, 637 A.2d at 43.

¹²⁶ *Id.*

¹²⁷ *Id.* at 43-44.

¹²⁸ *Id.* at 46-48.

interested in being a bidder.”¹²⁹ Also, the court found that the defensive tactics (*i.e.*, the pill, the no shop, the termination fee, and the stock option) were not reasonable.¹³⁰

In *Moore Corp. v. Wallace Computer Services, Inc.*,¹³¹ the acquiring corporation, Moore, made an acquisition proposal to Wallace, which was rejected.¹³² Moore then made an “any and all” tender offer at \$56 per share with a back end merger at that price.¹³³ Moore also started a proxy contest to unseat Wallace’s board of directors and redeem its pill.¹³⁴ The \$56 price was a 27% premium over the pre-offer price.¹³⁵ Wallace retained Goldman Sachs, which gave an opinion that the \$56 was “inadequate.”¹³⁶ Moore increased its offer to \$60, but Goldman gave another inadequacy opinion.¹³⁷ Goldman was not asked to value Wallace.¹³⁸

The court found that Wallace’s actions were defensive and that the *Unocal* standard, therefore, applied.¹³⁹ The court went on to find that Moore’s action posed a threat because the price offered was, under the circumstances, inadequate and that Wallace’s directors’ action in not redeeming the pill was proportionate, thereby satisfying the *Unocal* standard.¹⁴⁰ Thus, although 73.4% of Wallace’s shareholders tendered their shares to Moore,¹⁴¹ Wallace was permitted to “just say no” by keeping its pill in place.¹⁴²

In *Norfolk Southern Corp. v. Conrail, Inc.*,¹⁴³ CSX, a railroad company and the acquiror, entered into a merger agree-

¹²⁹ *Id.* at 47.

¹³⁰ *QVC*, 637 A.2d at 48-51.

¹³¹ 907 F. Supp. 1545 (D. Del. 1995).

¹³² *Moore*, 907 F. Supp. at 1550.

¹³³ *Id.* at 1551.

¹³⁴ *Id.* at 1550-51.

¹³⁵ *Id.* at 1551.

¹³⁶ *Id.* at 1551-52.

¹³⁷ *Moore*, 907 F.2d at 1553.

¹³⁸ *Id.* at 1552-53.

¹³⁹ *Id.* at 1553-54.

¹⁴⁰ *Id.* at 1560, 1564.

¹⁴¹ *Id.* at 1553.

¹⁴² *Moore*, 907 F. Supp. at 1563.

¹⁴³ *Norfolk S. Corp. v. Conrail, Inc.*, 1997 U.S. Dist. LEXIS 978, at *10-11 (E.D. Pa. Jan. 9, 1997).

ment with Conrail, also a railroad company and the target, pursuant to which CSX was to acquire Conrail in a multi-step acquisition for \$92.50 per share, which was later raised to \$110 per share.¹⁴⁴ Norfolk Southern, also a railroad company, and also a shareholder of Conrail, sought vigorously to block the merger and made a competing bid for Conrail at \$100 per share and then raised its offer to \$115 per share.¹⁴⁵

Conrail was a Pennsylvania corporation that was subject to the provisions of the Pennsylvania business corporation law governing takeovers.¹⁴⁶ The court specifically found that the intent of these Pennsylvania provisions is to reject such Delaware cases as *Unocal* and *Revlon*.¹⁴⁷

In a series of opinions from the bench, the District Court specifically found that the defensive measures employed by Conrail, including a poison pill and a no shop (which was effective for a two-year period) were in accord with Pennsylvania law.¹⁴⁸ Consequently, the Conrail board could keep its poison pill and other defensive measures intact.¹⁴⁹

Notwithstanding this decision, CSX and Norfolk Southern subsequently reached an agreement with Conrail pursuant to which CSX acquired Conrail for \$115 per share, and CSX and Norfolk then split up the Conrail assets.

As indicated below, if the change of control provision had applied in *Time-Warner*, *QVC*, *Moore*, and *Norfolk Southern*, either the likely outcomes would have been different or the outcome would have been similar but without the costs and expense of litigation.

5. Freezeout Mergers

*Weinberger v. UOP, Inc.*¹⁵⁰ involved a freezeout merger in which Signal Companies, Inc., a controlling shareholder of UOP with a 50.5% stock interest, acquired all of UOP's shares in a

¹⁴⁴ No. 76-7167, 1997 U.S. Dist. LEXIS 978 (E.D. Pa. Jan. 9, 1992).

¹⁴⁵ *Id.* at *15.

¹⁴⁶ *Id.* at *2.

¹⁴⁷ *Id.* at *5-7.

¹⁴⁸ *Id.* at *4-6.

¹⁴⁹ *Norfolk S.*, 1997 U.S. Dist., lexis 879, at *5-6.

¹⁵⁰ 457 A.2d 701 (Del. 1983).

cash merger transaction.¹⁵¹ Signal's executives, Arledge and Chithea, who were also directors of UOP, decided "that it would be a good investment for Signal" if it could acquire the minority held UOP shares for any price up to \$24 per share.¹⁵² Signal's executive committee settled on a price of \$20-21 per share, and Signal's board concluded that the \$20-\$21 price would be fair to both Signal's shareholders and UOP's shareholders.¹⁵³ Signal had previously paid \$21 for UOP shares, and the shares were now trading for almost \$14 per share.¹⁵⁴

Signal's executives met with UOP's president, Crawford, to discuss the deal.¹⁵⁵ Crawford, who had been a prior employee of Signal, did not object to the \$20-\$21 price, but he had other discussions regarding retention of UOP's employees.¹⁵⁶ Crawford retained the Lehman Brothers investment banking firm "to render a fairness opinion" on the transaction.¹⁵⁷ One of Lehman Brothers' partners was a member of UOP's board.¹⁵⁸

Lehman Brothers rendered an opinion that \$21 per share was fair.¹⁵⁹ The court noted that the opinion was prepared on a rush basis.¹⁶⁰ UOP's board met to consider the transaction and, with only the outside directors voting, the transaction was approved at the price of \$21 per share.¹⁶¹ The UOP board apparently was not advised that Signal's executives had concluded that any price up to \$24 per share would be a good investment for Signal.¹⁶²

The merger agreement was structured so that a majority of UOP's minority shareholders and two-thirds of all shareholders

¹⁵¹ *Weinberger*, 457 A.2d at 701.

¹⁵² *Id.* at 705.

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 704.

¹⁵⁵ *Id.* at 705.

¹⁵⁶ *Weinberger*, 457 A.2d at 705.

¹⁵⁷ *Id.* at 706.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at 707.

¹⁶⁰ *Id.* at 708.

¹⁶¹ *Weinberger*, 457 A.2d at 707.

¹⁶² *Id.*

were required to approve the transaction, and this approval was obtained.¹⁶³

Minority shareholders brought a class action alleging that the price paid was unfair.¹⁶⁴ In discussing the governing law, the Delaware Supreme Court reasoned that a controlling shareholder generally has the burden of establishing fairness in a freezeout merger.¹⁶⁵ However, the court held that if the merger has been approved by a majority of the minority shareholders and the controlling shareholder shows complete disclosure of all material facts, then "the burden entirely shifts to the plaintiffs to show that the transaction was unfair to the minority."¹⁶⁶ Here, the Supreme Court found a failure on the part of Signal to show complete disclosure.¹⁶⁷ The court held that Arledge and Chithea, as officers of both Signal and UOP, failed in their "duty of good management to both corporations."¹⁶⁸

The court's analysis centered around two fundamental aspects of the entire fairness doctrine: "fair dealing and fair price."¹⁶⁹ The concept of fair dealing asks courts to determine the fairness of all stages of negotiation between the parties involved.¹⁷⁰ Fair price considerations involve an examination of "the economic and financial considerations of the proposed merger."¹⁷¹ Courts weigh these concepts in order to make a general determination of the fairness of the transaction.¹⁷²

The court concluded Signal breached its duty of fairness under both tests.¹⁷³ Signal was not engaged in fair dealing because Arledge and Chithea failed to disclose to UOP directors that Signal considered as high as \$24 per share to be a fair purchase price of the remaining minority stock.¹⁷⁴ By virtue of

¹⁶³ *Id.* at 707-08.

¹⁶⁴ *Id.* at 703.

¹⁶⁵ *Id.*

¹⁶⁶ *Weinberger*, 457 A.2d at 703.¹⁶⁶12

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 705, 710-11.

¹⁶⁹ *Id.* at 711.

¹⁷⁰ *Id.*

¹⁷¹ *Weinberger*, 457 A.2d at 711.

¹⁷² *Id.*

¹⁷³ *Id.* at 712, 714.

¹⁷⁴ *Id.* at 712.

Signal's failure to disclose that fact, the court also found Signal breached its duty to negotiate a fair purchase of the minority shareholders' stock in UOP.¹⁷⁵

The court also suggested in a footnote that Signal should have adopted an independent negotiating structure for determining the price to be paid the minority shareholders:

Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's-length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered or pursued. Particularly in a parent-subsidary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's-length is strong evidence that the transaction meets the test of fairness.¹⁷⁶

The *Weinberger* court also decided that the Delaware block valuation formula was no longer the exclusive valuation methodology in Delaware and that any generally acceptable valuation technique could be utilized in determining fair value.¹⁷⁷ Further, the court said that for future cases, appraisal would be the exclusive remedy in the absence of "fraud, misrepresentation, self dealing, deliberate waste of corporate assets, or gross and palpable overreaching"¹⁷⁸

Although Signal did not employ the type of independent negotiating structure suggested by the Delaware Supreme Court, the independent directors of UOP and a majority of the minority shareholders approved the transaction.¹⁷⁹ As the court noted, however, neither the UOP independent directors

¹⁷⁵ *Id.* at 714.

¹⁷⁶ *Weinberger*, 457 A.2d at 709, n.7 (citations omitted).

¹⁷⁷ *Id.* at 712-13.

¹⁷⁸ *Id.* at 714.

¹⁷⁹ *Id.* at 707-08.

nor the public shareholders were fully informed.¹⁸⁰ Further, as the court indicated, the only negotiation engaged in by Lehman Brothers was over the fee it would charge for essentially a weekend's worth of work.¹⁸¹ Lehman Brothers did not appear to be very vigorous in its attempt to value UOP.

The Delaware Supreme Court's decision in *Kahn v. Lynch Communication Systems, Inc.* amplifies the application of the *Weinberger* principle.¹⁸² In *Lynch Communication Systems*, the court explained "[o]nce again, this court holds that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness."¹⁸³

The court further stated that although the controlling shareholder initially has the burden of establishing entire fairness, if the transaction is approved by an "independent committee of directors or an informed majority of minority shareholders," the burden of proof on the fairness issue shifts to the shareholder-plaintiff.¹⁸⁴ In this case, the court found that the "Court of Chancery's determination that the Independent Committee 'appropriately simulated a third-party transaction, where negotiations are conducted at arm's-length and there is no compulsion to reach an agreement,' [was] not supported by the record."¹⁸⁵ Consequently, the controlling shareholder had the burden of proof on the entire fairness question.¹⁸⁶

On remand, the Chancery Court applied the entire fairness test with the burden on the controlling parent and found that the defendant proved the merger's fairness.¹⁸⁷ Surprisingly, the Delaware Supreme Court affirmed despite evidence that

¹⁸⁰ *Id.* at 703.

¹⁸¹ *Weinberger*, 457 A.2d at 706.

¹⁸² *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110 (Del. 1994).

¹⁸³ *Lynch Communication Sys.*, 638 A.2d at 1117 (citing *Weinberger*, 452 A.2d at 710-11).

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* at 1121.

¹⁸⁶ *Id.*

¹⁸⁷ *Kahn v. Lynch Communications Sys., Inc.*, No. 8748, 1995 WL 301403, at *2-3 (Del. Ch. Apr. 17, 1995).

the controlling parent forced the transaction on an independent negotiating committee.¹⁸⁸

This series of decisions in *Lynch Communication* shows that, when courts apply Delaware's "entire fairness" test, it is first necessary to determine whether a special committee is indeed independent so that the burden of proof can be allocated. Then, it is necessary to apply close scrutiny on the entire fairness issue without regard to who has the burden of proof. This is at best a cumbersome process that, as shown in *Lynch Communication*, can produce strange results.

The defects in *Weinberger* and *Lynch Communication* would be cured by the adoption of a change of control board, which would in essence implement the suggestion in footnote 7 of the *Weinberger* decision, which proposes a "wholly independent board of directors acting upon the matter before them."¹⁸⁹

6. *Summary of Current Delaware Corporate Governance Rules for Mergers and Acquisitions*

The following table summarizes the current Delaware corporate law governance rules for mergers and acquisitions:

¹⁸⁸ Kahn v. Lynch Communication Sys., Inc., 669 A.2d 79, 80-81 (Del. 1995).

¹⁸⁹ Weinberger v. UOP, Inc., 457 A.2d 701, 709-10 n.7 (Del. 1983).

Summary of Current Law Governance Rules For Mergers and Acquisitions

[1] Arm's Length Mergers and Acquisitions	[2] Management Buyouts	[3] Defensive Tactics	[4] Freezeouts
TC's * BD** gets protection of the BJR.*** Generally no liability unless the board is "grossly negligent." See <i>Van Gorkom</i>.	Entire fairness test applies with burden on the interested shareholders, unless an independent committee is utilized. See <i>Dairy Mart</i>. However, if directors negotiating transaction for TC are completely independent of buyout group, the BJR may apply. See <i>RJR Nabisco, Inc. Shareholders' Litigation</i>.	Permissible if TC's BD has reasonable grounds for believing there is a threat to TC, and the response to the threat posed is reasonable. See <i>Unocal</i>. Response cannot be coercive or preclusive and must be within a range of reasonableness. See <i>Unitrin</i>. The burden is on TC's BD. If it becomes clear that TC is for sale and under certain other circumstances, TC must be sold in a fair auction. See <i>Revlon</i>.	Entire fairness test applies with burden on controlling shareholder, unless an independent committee is utilized, in which case the burden is on the ¶.**** See <i>Lynch Communication Systems</i>.

TC = Target Corporation
 BD = Board of Directors
 BJR = Business Judgment Rule
 ¶ = Plaintiff

7. *Economic Effects in the Above Conflicts and in the Merger and Acquisition Market Place Generally*

In several of the above cases, if the courts had not intervened, the targets' shareholders would have received substantially less than fair value for the shares they owned. This is true even though in each case the acquiror proposed to pay a price that was substantially more than the pre-acquisition trading price of the target's stock in regular market conditions. The adoption of the change of control board concept should ensure that in all cases the target's shareholders receive fair value for their shares.

Many economic studies have examined the price effects of merger and acquisition activity on both targets and acquirors. In general, the studies have found that target shareholders receive substantial premiums and that acquiror shareholders experience near zero returns. Professor Roberta Romano summarizes the evidence on targets as follows:

[A]cquisitions generate substantial gains to target company shareholders. All studies find that target firms experience statistically significant positive stock price responses to the announcement of takeover attempts or merger agreements. On average, there is a 20% increase over the pre-announcement market price for mergers and a 30% increase for tender offers in the period around the takeover announcement. Abnormal returns in going-private transactions (leveraged buyouts) are of a similar magnitude, ranging across studies between 20% and 37%. Without question the announcement of a bid is good news for target shareholders.¹⁹⁰

Professor Romano summarizes the evidence on acquirors as follows: "[t]he data are more ambiguous, however, concerning acquiring firms' returns. Depending on the sample and time

¹⁹⁰ Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 122 (1992).

period, acquirors experience positive, negative, or zero abnormal returns on a bid's announcement and completion."¹⁹¹

One might deduce from the economic evidence that target shareholders are generally receiving fair treatment in mergers and acquisitions and, therefore, a change of control board concept is not needed. This is the wrong conclusion for several reasons. First, even though target shareholders may on average benefit from mergers and acquisitions, the illustrative cases indicate that there is a real possibility that such shareholders may not benefit as much as they should. Second, the economic studies do not focus on those mergers and acquisitions that never occur because of the intransigence of the target's board and the unwillingness of bidders to push the point. Adoption of the change of control board concept will ensure that acquirors get a fair hearing without unnecessary roadblocks. Thus, the change of control board concept should increase the economic efficiency of the market for corporate control.

One aspect of the drag on economic efficiency caused by the current system is illustrated by the factual background facing the Delaware Chancery court in *Chesapeake Corp. v. Shore*.¹⁹² In this case, Shorewood, a publicly traded Delaware corporation, made an offer for Chesapeake, a publicly traded Virginia corporation.¹⁹³ The offer was at a premium of 41% over the pre-bid trading price of Chesapeake's shares.¹⁹⁴ Chesapeake had a continuing director or "dead-hand" poison pill, which is redeemable only by the directors of the target at the time of an offer or by the director's designees.¹⁹⁵ This type of pill is permissible in Virginia and other states, such as Georgia¹⁹⁶ that have pill validation statutes, but is not permissible in Delaware.¹⁹⁷ As the court explained, Chesapeake's dead-hand pill

¹⁹¹ *Id.* at 123.

¹⁹² No. 17626, 2000 Del. Ch. LEXIS 20 (Feb. 7, 2000).

¹⁹³ *Chesapeake*, 2000 Del. Ch. LEXIS 20, at *1-2.

¹⁹⁴ *Id.*

¹⁹⁵ *Id.* at *20-21.

¹⁹⁶ See, e.g., *Invacare Corp. v. Healthdyne Tech., Inc.*, 968 F. Supp. 1578, 1580 (N.D. Ga. 1997).

¹⁹⁷ See, e.g., *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

and staggered board provided "iron-clad defenses."¹⁹⁸ Chesapeake's board rejected Shorewood's offer and then made a counter offer for Shorewood at a 40% premium.¹⁹⁹ Shorewood's board took various defensive measures, which the court held, *inter alia*, did not satisfy the *Unocal* test. Thus, the court's decision made Shorewood more susceptible to Chesapeake's offer. This case illustrates that under our current federal system, companies incorporated in states with pill validation statutes like those in Virginia and Georgia can be made takeover proof if the boards so decide, whereas companies in Delaware and in other states that follow Delaware law cannot be made takeover proof. Economic efficiency is obviously deterred by this system that permits, for example, a Virginia corporation to takeover a Delaware corporation in a hostile offer, but prevents a Delaware corporation from taking over a Virginia corporation in a hostile transaction.

Third, the adoption of a change of control board concept should increase the number of transactions in which targets are disposed of in fair auctions and, therefore, should increase the consideration paid to the shareholders of such targets. This conclusion follows from the observation of Professor Romano that premiums are higher in tender offers than in negotiated mergers.²⁰⁰

Finally, each of the above cases illustrates that in the change of control context there is often no effective separation of what Professors Fama and Jensen call "decision management" and "decision control."²⁰¹ Decision management involves "initiation," that is, the "generation of proposals for resource utilization and structuring of contracts," and "implementation," that is, the "execution of ratified decisions."²⁰² Decision control involves "ratification," that is, the "choice of the decision initiatives to be implemented," and "monitoring," that

¹⁹⁸ *Chesapeake*, 2000 Del. Ch. LEXIS 20, at *20-21.

¹⁹⁹ *Id.* at *21-22.

²⁰⁰ Romano, *supra* note 190, at 122.

²⁰¹ Eugene Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 303-04 (1983); Michael C. Jensen, *FOUNDATIONS OF ORGANIZATIONAL STRATEGY* 1998).

²⁰² *Id.* at 303.

is, "measurement of the performance of decision agents and implementation of rewards."²⁰³ Because of the collective action problem facing shareholders in publicly held corporations, the boards of such companies, even if the boards have a majority of disinterested directors, effectively perform the functions of both decision management and decision control. Professors Fama and Jensen explain: "Without separation of decision management and decision control, residual claimants [e.g., public shareholders] have little protection against opportunistic actions of decision agents, and this lowers the value of unrestricted residual claims."²⁰⁴ They further explain that the "agency problems of diffuse decision management can . . . be reduced by separating the management (initiation and implementation) and control (ratification and monitoring) of decisions."²⁰⁵ The proposal here for a change of control board is consistent with the observation of Professors Fama and Jensen that "[e]ffective separation of top-level decision management and control means that outside directors have incentives to carry out their tasks and do not collude with managers to expropriate residual claimants . . . [O]utside directors have incentives to develop reputations as experts in decision control."²⁰⁶ Adoption of this proposal would insure that the change of control process is presided over by real outside directors.

C. The ALI's Governance Rules for Mergers and Acquisitions

1. Introduction

The Corporate Governance Project sets forth governance rules for, *inter alia*, the four transactions addressed here: arm's-length mergers and acquisitions; management buyouts; defensive tactics in tender offers; and freezeouts.²⁰⁷ The ALI's treatment of each of these transactions is discussed in the following sections.

²⁰³ *Id.*

²⁰⁴ *Id.* at 305-06.

²⁰⁵ *Id.* at 308.

²⁰⁶ *Id.* at 325.

²⁰⁷ See CORPORATE GOVERNANCE PROJECT, *supra* note 2.

2. Arm's-length Mergers and Acquisitions

Section 6.01 of the Corporate Governance Project governs the actions of a target's board in all forms of arm's-length mergers and acquisitions.²⁰⁸ This provision authorizes a target's board "in the exercise of its business judgment . . . [to] 'approve, reject or decline to consider a proposal'" to engage in a merger or acquisition (*i.e.*, a transaction in control).²⁰⁹ Specific rules regarding the board's duty of care and the protection afforded by the business judgment rule are set forth in section 4.01.²¹⁰ The rules in section 4.01 apply generally and to arm's-length mergers and acquisitions under section 6.01. Thus, section 6.01 gives a target's board wide latitude in responding to an arm's-length merger or acquisition proposal, and the board's decisions will be protected by the business judgment rule in section 4.01(c) as long as (1) the director's business judgment is made in good faith, and (2) the director (a) is not interested in the transaction, (b) "is informed with respect to the subject of the business judgment," and (c) "rationally believes that the business judgment is in the best interests of the corporation."²¹¹ The business judgment rule also protects the directors of an acquiring corporation.²¹²

Under section 7.24, appraisal by the court that hears the dispute is the exclusive remedy a shareholder has for challenging an arm's-length transaction.²¹³ As a practical matter, however, appraisal proceedings will be rare, because under section 7.22(b), in an arm's-length transaction, the price accepted by the target's board is presumed to be fair value "unless the plaintiff can prove otherwise by clear and convincing evidence."²¹⁴ Thus, the appraisal rules for arm's-length transactions are structured to discourage the use of appraisal proceedings.

²⁰⁸ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.01(a).

²⁰⁹ See Thompson, *supra* note 2, at 169. (quoting CORPORATE GOVERNANCE PROJECT, § 6.01(a)).

²¹⁰ See Thompson, *supra* note 2, at 157.

²¹¹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 4.01(c).

²¹² See Thompson, *supra* note 2, at 165.

²¹³ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.24.

²¹⁴ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.22(b).

3. Management Buyouts

Section 5.15 of the Goverate Governance Project governs management buyout transactions, which are mergers and acquisitions in which the directors or principal executive officers of the target have an interest in the acquiring vehicle.²¹⁵ In these transactions, the general rule is that "interested directors/executives have the burden of proving the transaction is fair to the target's shareholders."²¹⁶ However, if the following four conditions are satisfied, the challenging party has the burden of proving waste of corporate assets.²¹⁷ The conditions are: (1) public disclosure of the proposed transaction must be made, (2) responsible potential bidders must be provided with the relevant information and must be "given a reasonable opportunity to submit a competing proposal" (that is, the transaction must be market tested), (3) the transaction must be approved by disinterested directors, and (4) the transaction must be approved, or the tender offer accepted, by disinterested shareholders.²¹⁸

Although appraisal is not the exclusive remedy for dissenting shareholders in a management buyout, if the transaction is market-tested and approved by disinterested directors and shareholders as specified in section 5.15(b), it is likely that the accepted price would constitute fair value.²¹⁹ Consequently, if such a mechanism is utilized, it is unlikely that there would be a challenge either on the grounds of waste of corporate assets or in an appraisal proceeding. Thus, appraisal can effectively be avoided in management buyouts by using market test procedures and securing the approval of disinterested directors and shareholders.

If these market test and disinterested director/shareholder procedures are followed, the practical result is the same as that reached in arm's-length transactions governed by section 6.01 and the business judgment rule of section 4.01(c). However, if

²¹⁵ See Thompson, *supra* note 2, at 206.

²¹⁶ Thompson, *supra* note 2, at 207.

²¹⁷ See Thompson, *supra* note 2, at 207-08.

²¹⁸ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 5.15(b).

²¹⁹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 5.15(c).

this approach were adopted, there would likely be substantial litigation over whether the directors were truly disinterested, the transaction was adequately market tested, and the shareholders were adequately informed. These questions would not likely arise with a change of control board.

4. *Defensive Tactics in Tender Offers*

Section 6.02 of the Corporate Governance Project governs actions of a target's board that have the "foreseeable effect of blocking an unsolicited tender offer."²²⁰ The directors may take such defensive action as long as the action is a "reasonable response to the offer."²²¹

"In [determining] whether [an] action is a reasonable response to [an] offer," the target's board may take into account all relevant factors including "questions of legality" and whether the offer, if successful, would "threaten the corporation's essential economic prospects."²²² Further, the target's board may "have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of the shareholders."²²³

Under Section 6.02(c), the challenging party has the burden of proving "that the board's action is an unreasonable response to the offer."²²⁴ Thus, although the Corporate Governance Project explains that the standards in section 6.02 are "intended to be consistent" with the enhanced or intermediate standard of review set forth in the Delaware Supreme Court's decision in *Unocal*,²²⁵ the burden under section 6.02 is on the challenging party.²²⁶ This should be contrasted with the *Unocal* decision, which places the burden on the target's direc-

²²⁰ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02(a).

²²¹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2; see generally Thompson, *supra* note 2, at 224-26.

²²² See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02(b)(1).

²²³ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02(b)(2).

²²⁴ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02(c).

²²⁵ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02 cmt. a; see also *supra* notes 67-73 and accompanying text.

²²⁶ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02, cmt. a.

tors to prove that their action in blocking a tender offer was a reasonable response.²²⁷

Thus, section 6.02 sets out a standard of reasonableness that is higher than the "rationally believes" standard of the business judgment rule in section 4.01(c) that applies in arm's-length mergers and acquisitions under section 6.01.²²⁸ Under the business judgment rule, the decision of the target's directors need not be a reasonable response.²²⁹ As long as the directors act in good faith, are not interested, and are informed, the business judgment rule applies if they "rationally believe" that their business judgment is in the best interest of the corporation.²³⁰ The Corporate Governance Project explains that the "rationally believes" test is "intended to afford directors and officers wide latitude when making business decisions" and that "[s]ound public policy dictates that directors and officers be given greater protection than . . . a 'reasonableness' test would afford."²³¹ Even though section 6.02 adopts a reasonableness standard, the Corporate Governance Project makes clear that a target's directors are given wide latitude in responding to a hostile tender offer.²³²

The Corporate Governance Project provides, however, that "there will be [some] sets of facts where the board will not be able to block the tender offer and satisfy the requirements of § 6.02."²³³ Unfortunately, the Corporate Governance Project does not give an illustration of such a set of facts. Also, the Corporate Governance Project says that under the Section 6.02 standard, a court faced with the facts in the *Paramount* case would likely reach the result the Supreme Court of Delaware reached in that case.²³⁴ This would likely not be the result with a change of control board. Because the burden is on the challenging party rather than on the target's board, as under

²²⁷ See CORPORATE GOVERNANCE PROJECT, *supra* note 2.

²²⁸ See CORPORATE GOVERNANCE PROJECT, *supra* note 2.

²²⁹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 4.01 cmt. c.

²³⁰ See CORPORATE GOVERNANCE PROJECT, *supra* note 2.

²³¹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 4.01 cmts. e. & f.

²³² See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02 cmt. c(8).

²³³ See CORPORATE GOVERNANCE PROJECT, *supra* note 2.

²³⁴ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02, rprr. n.3.

the Delaware *Unocal* test, adoption of the section 6.02 standard would likely make it more difficult to challenge the actions of an entrenched board.

5. Freezeouts

The Corporate Governance Project divides freezeout transactions into those in which the controlling shareholder does not have sufficient voting control to unilaterally effectuate the transaction (*i.e.*, non-majority control freezeouts) and those in which such unilateral voting power exists, as is the case with short form-mergers (*i.e.*, majority control freezeouts).²³⁵

Non-majority control freezeouts are governed by section 5.10.²³⁶ Section 5.10(a) provides that a controlling shareholder satisfies its duty of fair dealing if either "(1) the transaction is fair to [the target] when entered into;" or (2) after disclosure, the transaction is approved by disinterested shareholders and does not constitute a waste of corporate assets."²³⁷

Under section 5.10(b), if disclosure is made and the transaction is approved by disinterested directors or disinterested shareholders, the challenging party has the burden of proving a waste of corporate assets.²³⁸ If this procedure is not followed, the controlling shareholder has the burden of proving the transaction is fair.²³⁹

Although appraisal is not the exclusive remedy in non-majority control freezeouts, if the disclosure and disinterested director/shareholder procedures are followed as a practical matter, the consideration paid in the transaction should constitute fair value and the transaction should not constitute a waste of corporate assets.

Majority control freezeouts are subject to section 5.10 unless the following four conditions of section 7.25 are satisfied.²⁴⁰ First, the directors who approve the transaction must

²³⁵ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, §§ 5.10, 7.25.

²³⁶ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 5.10.

²³⁷ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 5.01(a).

²³⁸ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 5.01(b).

²³⁹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2.

²⁴⁰ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.25 cmt. c.

have an "adequate basis, grounded on substantial objective evidence, for believing that the consideration offered to the minority shareholders . . . constitutes fair value for their shares."²⁴¹ Second, full disclosure must be made to minority shareholders.²⁴² Third, the transaction must be approved pursuant to state law and the "corporation's charter documents."²⁴³ Finally, dissenting shareholders must have an appraisal right.²⁴⁴ If these four conditions are met, appraisal is the exclusive remedy.²⁴⁵

Under Section 7.25(b), the controlling shareholder has the burden of proving compliance with these four conditions, unless the transaction was approved by disinterested directors and disinterested shareholders.²⁴⁶ In such a case, the burden is on the challenging party.²⁴⁷

In summary, if disinterested directors negotiate with the controlling shareholder concerning the price of the transaction and the parties agree on a price that is approved or ratified by disinterested shareholders, then the burden is on the challenging party to establish that one of the four conditions is not satisfied. If the challenging party meets this burden, appraisal is not the exclusive remedy.

As a practical matter, if an independent negotiating structure is utilized, the controlling shareholder will have an "adequate basis" for believing that the price constitutes fair value, and assuming the other conditions are satisfied (which will normally be the case), appraisal will be the exclusive remedy. Furthermore, the price set by the independent negotiating structure would normally be found to constitute fair value in an appraisal proceeding. However, under this approach disputes will undoubtedly arise concerning whether the negotiating structure is indeed independent; this would not be an issue with a change of control board.

²⁴¹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.25(a)(1).

²⁴² See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.25(a)(2).

²⁴³ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.25(a)(3).

²⁴⁴ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.25(a)(4).

²⁴⁵ See CORPORATE GOVERNANCE PROJECT, *supra* note 2.

²⁴⁶ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.25(b).

²⁴⁷ See CORPORATE GOVERNANCE PROJECT, *supra* note 2.

6. Summary of ALI's Governance Rules for Mergers and Acquisitions

The following table summarizes the above Merger and Acquisition Rules:

SUMMARY OF ALI'S MERGER AND ACQUISITION RULES				
[1]	[2]	[3]	[4]	[5]
§ 6.01 Arm's Length Mergers & <u>Acquisitions</u>	§ 5.15 Management <u>Buyouts</u>	§ 6.02 Defensive <u>Tactics</u>	§5.10 Non-Majority Control <u>Freezeouts</u>	§ 7.25 Majority Control <u>Freezeouts</u>
(a) 6.01: Wide latitude for TC's* BD** to act	(a) 5.15: Interested Directors/Executives have burden of proving transaction is fair unless 5.15(b) applies.	(a) 6.02: Target's BD may take action having foreseeable effect of blocking a tender offer if such action is <i>reasonable</i> response to the offer.	(a) 5.10(a): Controlling shareholder satisfies duty of fair dealing if either (1) transaction is fair, or (2) after disclosure transaction is approved by disinterested shareholders and transaction is not a waste.	(a) 7.25: Subject to 5.10 <i>unless</i> :

[1]	[2]	[3]	[4]	[5]
§ 6.01 Arm's Length Mergers & <u>Acquisitions</u>	§ 5.15 Management <u>Buyouts</u>	§ 6.02 Defensive <u>Tactics</u>	§5.10 Non-Majority Control <u>Freezeouts</u>	§ 7.25 Majority Control <u>Freezeouts</u>
(b) 4.01: Duty of Care	(b) Under 5.15(b): ¶**** has burden of proving waste if: (1) Public disclosure, (2) Market tested, (3) Approved by disinterested directors, and (4) Transaction approved or tender offer accepted by disinterested share-holders.	(b) Reasonable is higher standard than rational standard under BJR.	(b) 5.10(b): burden on if disclosure and transaction approved by disinterested directors or shareholders. must prove waste.	(b) 7.25 applies and appraisal is exclusive remedy. See (c).
(c) 4.01(c): BJR*** Protection if: (1) Good faith, (2) Not interested, (3) Informed, (4) Rationally believes in best interest of the corporation.	(c) Appraisal not exclusive remedy. However, if 5.15(b) followed likely effect no waste and merger price = fair value.	(c) TC's BD can consider whether offer threatens TC's essential economic prospects and may consider other constituencies as long as such action does not significantly disfavor long-term interest of the shareholders.	(c) Appraisal not exclusive remedy.	(c) Under 7.25: (1) directors must have adequate basis for concluding price = fair value (2) disclosure, (3) procedural approvals, (4) dissenting shareholder must have appraisal right.
(d) 7.24: Appraisal is exclusive remedy.		(d) Burden of proving unreasonableness on challenging party.	(d) But if disclosure and disinterested, no waste and price = fair value.	(d) Under 7.25(b) burden on ¶ parent unless approved by disinterested directors and disinterested shareholders.

e) 7.22: Merger price fair value unless proof otherwise by clear and convincing evidence.				(e) If not 7.25 then must meet 5.10.
---	--	--	--	--------------------------------------

*TC = Target Corporation
** BD = Board of Directors
*** BJR = Business Judgment Rule
**** ¶ = Plaintiff

7. *Comment on the ALI's Approach*

The ALI's rules are quite complex; however, the bottom line is that if disinterested directors act in each of the transactions, courts will find the amount paid to be fair. This is, in essence, a disinterested director approach, which, for the reasons outlined below, is fundamentally flawed. Also, the ALI's approach to defensive tactics in tender offers is even more protective of the target's directors than is Delaware law with its *Unocal* standard, because the burden of proof is on the plaintiff, instead of the director, as would be the case under the *Unocal* standard.²⁴⁸

For these reasons, the change of control concept is superior to the ALI's approach. However, the ALI's formulation of the business judgment rule in section 4.01 and its basic formulation of the standard governing tender offers in section 6.02 is adopted here under the proposed change of control board standard.²⁴⁹

III. OPERATION OF CHANGE OF CONTROL BOARD

A. *Introduction*

This section discusses the operational rules governing the change of control board. The specific statutory language is set forth in Proposed Section 14A to the Securities Exchange Act of 1934, which is set out in the Appendix.²⁵⁰ Also, this section discusses the effects on certain collateral provisions of the 1934 Act and the Internal Revenue Code.

B. *Corporations Subject to the Rules*

Unless public shareholders vote to elect-out of Proposed Section 14A (an option available under the proposed law), Proposed Section 14A applies to domestic public corporations with respect to which a trigger event occurs.²⁵¹ Such public corporations are referred to in Proposed Section 14A(a) as "affected

²⁴⁸ See *supra* notes 72, 226 and accompanying text.

²⁴⁹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, §§ 4.01, 6.02.

²⁵⁰ See *infra* app. § 14A.

²⁵¹ See *infra* app. § 14A(a).

issuers.”²⁵² A public corporation is any corporate issuer that satisfies the asset and shareholder test of § 12(g) of the 1934 Act.²⁵³ Under § 12(g)(1), every issuer engaged in interstate commerce or in an activity affecting interstate commerce or whose securities are traded in interstate commerce, is required to register such securities with the SEC, provided the issuer has total assets exceeding \$10 million and equity securities held of record by five hundred or more persons.²⁵⁴ Although under § 12(g), issuers that are not corporations may be required to register, the control board concept applies to only domestic corporate issuers that have more than \$10 million in assets and at least 500 shareholders.²⁵⁵

Five types of trigger events are specified in Proposed Section 14A(b).²⁵⁶ Section 14A(b)(1) encompasses all forms of arm’s-length consensual mergers and acquisitions proposed to a target’s board, including arm’s-length mergers, management buyouts, and freezeouts.²⁵⁷ This concept, therefore, includes proposed direct or subsidiary mergers that include target acquisitions and proposals to acquire substantially all of the target’s assets.²⁵⁸

Proposed Section 14A(b)(2) encompasses proposed mergers or acquisitions that are initiated by the target’s management—such as occurred in *Van Gorkom*.²⁵⁹

Proposed Section 14A(b)(3) encompasses hostile tender offers for public corporations.²⁶⁰ Proposed Section 14A(b)(4) involves transactions in which a Schedule 13D, indicating an acquisition of more than 5% of the issuer’s stock, is filed with respect to a public corporation, provided the purpose of the

²⁵² See *infra* app. § 14A(a).

²⁵³ See *infra* app. § 14A(a).

²⁵⁴ 15 U.S.C. § 78l(g)(1)(B) (1994); see 17 C.F.R. 240.12(g)(1).

²⁵⁵ See 15 U.S.C. § 78l(g)(1)(B).

²⁵⁶ See *infra* app. § 14A(b).

²⁵⁷ See *infra* app. § 14A(b)(1).

²⁵⁸ See *infra* app. § 14A(b)(1). A subsidiary merger involves a merger between a wholly-owned subsidiary (Sub) of the acquiring corporation and the target. In a reverse subsidiary merger, the Sub merges into the target with the target’s shareholders receiving the merger consideration and the target becoming a wholly-owned subsidiary of the acquiring corporation. In a forward subsidiary merger, the target merges into the Sub.

²⁵⁹ See *infra* app. § 14A(b)(2); see also *supra* notes 19-34 and accompanying text [citation to provisions discussion of *Van Gorkom*].

²⁶⁰ See *infra* app. § 14A(b)(3).

acquisition is, or may be, to effectuate an acquisition of the issuer.²⁶¹ Thus, if the Schedule 13D indicates that the acquiror has a bona fide potential change of control purpose, then a trigger event has occurred.

Proposed Section 14A(b)(5) encompasses situations in which a public acquiring corporation acquires the stock or assets of another corporation in exchange for stock of the acquiring corporation that exceeds 50% of the acquiring corporation's outstanding stock after the acquisition.²⁶² Thus, this type of trigger event involves a so-called "upside-down" acquisition in which a small corporation acquires, in exchange for its stock, the stock or assets of a large corporation. In such cases, the acquiring corporation is deemed to have experienced a trigger event. Thus, Proposed Section 14A(b)(5), in essence, would codify one aspect of the *de facto* merger doctrine.²⁶³

In addition to the trigger event under Proposed Section 14A(b)(5) for the public acquiring corporation, a trigger event will also occur under Proposed Section 14A(b)(1) with respect to the target if it is a public corporation.²⁶⁴ Thus, in such cases both the public acquiror and the public target are affected issuers. This would be the case, for example, in a situation such as the proposed original merger between Time Inc. and Warner Communications, Inc.²⁶⁵ In that transaction, it was proposed that Time acquire Warner in a reverse subsidiary merger in which the shareholders of Warner would have owned approximately 62% of Time after the merger, and Warner would have become a wholly-owned subsidiary of Time.²⁶⁶ Under Proposed Section 14A(b)(1), a trigger event would have occurred with respect to Warner since Time proposed a merger between the two companies.²⁶⁷ Also, under Proposed Section 14A(b)(5), a trigger event would have occurred with respect to Time since it was proposed that Time issue in the acquisition its stock amounting to in excess of 50% of Time's outstanding shares

²⁶¹ See *infra* app. § 14A(b)(4).

²⁶² See *infra* app. § 14A(b)(5).

²⁶³ See *infra* app. § 14A(b)(5) cmt. 1.

²⁶⁴ See *infra* app. §§ 14A(b)(1), (b)(5).

²⁶⁵ *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1144 (Del. 1989).

²⁶⁶ *Paramount*, 571 A.2d at 1141-49.

²⁶⁷ See *infra* app. § 14A(b)(1); *Paramount*, 571 A.2d at 1146.

after the transaction.²⁶⁸ Consequently, both Time and Warner would have been affected issuers under Proposed Section 14A(a), and, under Proposed Section 14A(c), which is discussed below, a change of control board would have been appointed with respect to each such corporation.²⁶⁹

C. Change of Control Official

Upon the happening of a trigger event with respect to a public corporation, Proposed Section 14A(c)(1) imposes a duty on the target's board to petition the Change of Control Official for the appointment of a change of control board.²⁷⁰ Under Proposed Section 14A(c)(2), if the target's board does not promptly file such a petition either the SEC or a shareholder or shareholders owning at least 5% of the target's shares may file the petition instead.²⁷¹

Under Proposed Section 14A(d), the Change of Control Official is a non-political appointee of the SEC, and the appointee is not to "be identified with any particular change of control theory or ideology."²⁷² A majority of the members of the Federal Reserve Board must concur in the appointment.²⁷³ This concurrence procedure should help ensure that the Change of Control Official is indeed non-political and does not have a particular philosophy regarding change of control transactions. The SEC may, if it deems appropriate, appoint Change of Control Officials for various sections of the country.²⁷⁴

The Change of Control Official or Officials perform functions similar to those of a United States Trustee in a bankruptcy proceeding.²⁷⁵ The primary functions of the Change of Control Official are: (1) the identification of qualified persons willing to serve on a change of control board, and of qualified attorneys, investment bankers, and other merger and acquisition

²⁶⁸ See *infra* app. § 14A(b)(5); *Paramount*, 571 A.2d at 1148.

²⁶⁹ See *infra* app. § 14A(c).

²⁷⁰ See *infra* app. § 14A(c)(1).

²⁷¹ See *infra* app. § 14A(c)(2).

²⁷² See *infra* app. § 14A(d)(1).

²⁷³ See *infra* app. § 14A(d)(1).

²⁷⁴ See *infra* app. § 14A(d)(1).

²⁷⁵ DAVID G. EPSTEIN, STEVE H. NICKLES AND JAMES J. WHITE, *BANKRUPTCY* § 1-4 (1993).

specialists willing to provide advice to change of control boards, (2) the appointment of change of control boards, and (3) consulting with change of control boards regarding the hiring by such boards of professional advisors.²⁷⁶ All other duties would be governed by SEC rules and regulations.

Proposed Section 14A(e) sets forth the rules regarding the appointment of the members of a change of control board.²⁷⁷ The Change of Control Official must make such appointments promptly after the receipt of a petition.²⁷⁸ The change of control board is to consist of three members unless the Change of Control Official decides that, under the circumstances, it is appropriate to appoint more than three.²⁷⁹ No more than five members may be appointed.²⁸⁰

In making the appointments, the Change of Control Official must first insure that each member is not interested in the proposed transaction.²⁸¹ The determination of whether a member is interested is to be made pursuant to rules to be promulgated by the SEC.²⁸² It is contemplated that such rules will be broader than the rules under current law and the provisions of the Corporate Governance Project for determining whether a party is interested in the transaction.

In making the selections, the Change of Control Official should also give consideration to the proposed member's experience in dealing with change of control transactions, and, in appropriate cases, should give consideration to the prospective member's knowledge of the particular industry.²⁸³ This selection process should maximize the possibility that the members of a change of control board will be free of any possible conflict and will have the experience needed to do an effective job. Further, the Change of Control Official should be satisfied that each member will: (1) act in good faith, (2) make a proper in-

²⁷⁶ See *infra* app. § 14A(d)(2). This identification process should be an ongoing process, so that once a change of control takes place, appointment of the change of control board and its advisors could be made from a list of individuals who have already been identified.

²⁷⁷ See *infra* app. § 14A(e).

²⁷⁸ See *infra* app. § 14A(e).

²⁷⁹ See *infra* app. § 14A(e).

²⁸⁰ See *infra* app. § 14A(e).

²⁸¹ See *infra* app. § 14A(e).

²⁸² See *infra* app. § 14A(e).

²⁸³ See *infra* app. § 14A(e).

quiry, and (3) rationally believe that any decision made is in the best interest of the corporation.²⁸⁴ Thus, the Change of Control Official will be required to make an *ex ante* judgment that each member of the change of control board will satisfy the duty of care standard and will be protected by the business judgment rule set forth in Proposed Section 14A(i).²⁸⁵

The Change of Control Official may, in appropriate circumstances, appoint to the change of control board one member (and no more than one) of the target's regular board who is otherwise qualified to serve.²⁸⁶ The Change of Control Official should make every effort to make such an appointment because such a member could provide continuity and helpful insights.²⁸⁷ However, a member of the regular board should not be appointed unless the Change of Control Official is convinced that the person clearly is disinterested.²⁸⁸

It should be anticipated that in most cases the members of a change of control board would reside in the geographic area in which the affected issuer has its headquarters, thereby facilitating meetings of the change of control board and minimizing travel delay and costs.

Once appointed, the members of the change of control board will continue to serve until resignation by the member or dissolution of the board.²⁸⁹

D. Responsibilities and Authority of Change of Control Board

1. In General

Proposed Section 14A(f) sets out the responsibilities and authority of the members of a change of control board.²⁹⁰ In essence, such boards, acting by a majority vote, have full power over all matters relating to a proposed change of control transaction involving the affected issuer.²⁹¹

First, the change of control board has the power to decide whether to consider, accept, or reject a proposal to enter into a

²⁸⁴ See *infra* app. § 14A(e).

²⁸⁵ See *infra* app. § 14A(i)(3)-(4).

²⁸⁶ See *infra* app. § 14A(e).

²⁸⁷ See *infra* app. § 14A(e).

²⁸⁸ See *infra* app. § 14A(e).

²⁸⁹ See *infra* app. § 14A(e).

²⁹⁰ See *infra* app. § 14A(f).

²⁹¹ See *infra* app. § 14A(f)(1) cmt. 1.

merger or acquisition.²⁹² This power is similar to that specified in section 6.01 of the Corporate Governance Project for arm's-length mergers and acquisitions.²⁹³

Second, such boards have the power to implement defensive tactics that may have the foreseeable effect of blocking the offer.²⁹⁴ This power is similar to the principle set out in section 6.02 of the Corporate Governance Project relating to hostile tender offers.²⁹⁵ Such tactics include the issuance of a poison pill, provided that state law or the corporation's charter authorizes any such action.²⁹⁶ Thus, the change of control board may not take any action that the corporation's regular board would be prohibited from taking by state law or the charter documents.²⁹⁷

The current state of the empirical evidence bearing on the efficacy of the poison pill would support granting the change of control board the power to use a pill as it deems appropriate. For example, the recent works of Professor Coates challenge the conclusions reached by many academics on the basis of event studies that poison pills harm a target's shareholders.²⁹⁸ On the other hand, he also criticizes premium studies that many have relied on as support for the view that pills are beneficial to a target's shareholders.²⁹⁹ His analysis led to the following principal conclusions: (1) "Institutional shareholders should be aware of the fact that half the traditional academic case (at least) against defenses stands on shaky ground . . ."³⁰⁰ (2) "Boards . . . should not be permitted to rely without caveat on pill premium studies to support a decision to adopt a pill at a given point in time,"³⁰¹ and (3) "Delaware courts . . . should

²⁹² See *infra* app. § 14A(f)(1)(i).

²⁹³ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.01.

²⁹⁴ See *infra* app. § 14A(f)(1)(v), (f)(3).

²⁹⁵ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02.

²⁹⁶ See *infra* app. § 14A(f)(3).

²⁹⁷ See *infra* app. § 14A(f)(3).

²⁹⁸ John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 277 (2000) [hereinafter Coates, *Takeover Defenses*]; John C. Coates IV, *Empirical Evidence on Structural Takeover Defenses: Where Do We Stand?*, 54 MIAMI L. REV. 783 (2000) [hereinafter Coates, *Empirical Evidence*].

²⁹⁹ Coates, *Empirical Evidence*, *supra* note 298, at 785.

³⁰⁰ Coates, *Empirical Evidence*, *supra* note 298, at 797; see also Coates, *Takeover Defenses*, *supra* note 298, at 338.

³⁰¹ Coates, *Empirical Evidence*, *supra* note 298, at 797; see also Coates, *Take-*

take some comfort from the fact that they resisted strong academic arguments . . . to push them to dramatically repudiate pills and other structural defenses³⁰²

While a change of control board would have the power to issue a traditional pill, it would have no reason to issue a continuing director or deadhand pill like the ones found invalid under Delaware law in *Carmody v. Toll Brothers*³⁰³ but valid under Georgia law in the *Invacare Corp. v. Healthdyne Technologies, Inc.*³⁰⁴ Also, a change of control board would have no reason to issue a delayed redemption pill like the one found invalid under Delaware law in *Quickturn Design Systems, Inc. v. Shapiro*.³⁰⁵ In this type of pill, the replacement board appointed after a successful proxy contest is prohibited from redeeming the target's pill for a specified period. Thus, these issues concerning the validity of attempts by boards to deter proxy contests by restricting the ability of a new board to redeem a pill would not be of concern under the change of control provisions.

Third, the change of control board has complete responsibility and authority over the preparation of proxy statements, information statements and other disclosure documents relating to the change of control transaction.³⁰⁶ The change of control board can in appropriate circumstances delegate these and other matters to the target's officers. The change of control board has the authority to negotiate with antitrust and other regulatory authorities and to make divestiture decisions that may be required by such authorities. The change of control board would, however, consult closely with the regular board before making any divestiture.

Fourth, such board has control over the preparation of the target's response to a tender offer on Schedule 14D-9 under the 1934 Act.³⁰⁷

over *Defenses*, *supra* note 298, at 338.

³⁰² Coates, *Empirical Evidence*, *supra* note 298, at 797; see also Coates, *Takeover Defenses*, *supra* note 298, at 338.

³⁰³ 723 A.2d 1180 (Del. Ch. 1998).

³⁰⁴ 968 F. Supp. 1578. (N.D. Ga. 1997).

³⁰⁵ 761 A.2d 1281 (Del. 1998).

³⁰⁶ See *infra* app. § 14A(f)(1)(ii).

³⁰⁷ See *infra* app. § 14A(f)(1)(iii).

Fifth, such boards have the authority to cause the corporation to make "golden parachute" and similar severance payments to key employees of the target.³⁰⁸ The regular board would have no power over such payments. The change of control board could thus take appropriate steps to ensure the continued services of key employees.

Sixth, such boards may cause the corporation to redeem its stock at a premium in a "greenmail" transaction.³⁰⁹ The corporation's regular board would have control over redemption programs that are not connected with a potential change of control transaction.

Seventh, change of control boards have the authority to cause the corporation to enter into various types of lock-up agreements, such as stock options and no shops, to protect a negotiated merger or acquisition transaction.³¹⁰ Stock options give the acquiror the right to buy stock in the target at premerger (bargain) prices if a third party acquires the target, and no shops prevent the target's board from seeking a better deal from a third party, subject to certain fiduciary obligations to the target's shareholders.

Eighth, the change of control board may cause the corporation to pay various types of fees to induce a potential acquiror to enter the bidding, such as "hello fees" and "goodbye (i.e., termination) fees."³¹¹

The law in Delaware governing deal protection devices like stock options, termination fees, and no shops is not yet settled.³¹² For example, in *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,³¹³ Chancellor Chandler expressed the view that "no talk" provisions are "troubling" and may amount to "willful blindness."³¹⁴ He further observed that the termination fee in that case "probably stretches the definition [of range of reasonableness] beyond its breaking point."³¹⁵ Along the same lines, Vice Chancellor Strine in *ACE Limited v. Capital Re Corpora-*

³⁰⁸ See *infra* app. § 14A(f)(1)(iv).

³⁰⁹ See *infra* app. § 14A(f)(1)(v).

³¹⁰ See *infra* app. § 14A(f)(1)(vii).

³¹¹ See *infra* app. § 14A(f)(1)(viii).

³¹² See, e.g., Gregory V. Varallo & Srinivas M. Raju, *A Process Based Model for Analyzing Deal Protection Measures*, 55 BUS. LAW. 1609 (2000).

³¹³ No. 17383, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999).

³¹⁴ *Phelps Dodge*, 1999 Del. Ch. LEXIS 202, at *4.

³¹⁵ *Id.* at *5.

tion³¹⁶ found that the no talk there was likely invalid. He reasoned that "[w]hen corporate boards assent to provisions in merger agreements that have the primary purpose of acting as a defensive barrier to other transactions not sought out by the board, some of the concerns that animated the *Unocal* standard of review might be implicated."³¹⁷ On the other hand, in *In re IXC Communications, Inc. Shareholders Litigation v. Cincinnati Bell, Inc.*³¹⁸ Vice Chancellor Steele applied the business judgment rule in validating a termination fee, a stock option and a no shop that were not "defensive mechanisms instituted to respond to a perceived threat to a potential acquiror."³¹⁹ The standard of review for a change of control board that employed any of these deal protection devices would be the business judgment rule set out in Proposed Section 14A(i)(4), which is discussed in Section III.E. below.

The change of control board may, with the approval of the Change of Control Official, hire its own independent attorney, investment banker, or any other professionals necessary for it to carry out its business.³²⁰ Since such professionals will be hired directly by the change of control board, they should be free of the conflicts that have infected professionals in the acquisitions detailed by Chancellor Allen.³²¹

Proposed Section 14A(f)(4) requires the corporation's regular board to cooperate fully with the change of control board.³²² It is anticipated that the change of control board will, in appropriate cases, consult extensively with the target's regular board concerning the merits of the proposed merger or acquisition. Also, the change of control board may consult with certain influential shareholders of the target company.

If the regular board does not cooperate, the change of control board may petition a court to suspend the regular board and transfer all of its responsibilities to the change of control board.³²³ The members of a change of control board are not to

³¹⁶ 747 A.2d (Del. Ch. 1999).

³¹⁷ *ACE Ltd.*, 747 A.2d at 108.

³¹⁸ No. 17324, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999).

³¹⁹ *Cincinnati Bell*, 1999 Del. Ch. LEXIS 210 at *29.

³²⁰ See *infra* app. § 14A(f)(2).

³²¹ See *infra* Part V.

³²² See *infra* app. § 14A(f)(4).

³²³ See *infra* app. § 14A(b)-(4).

be considered as governmental employees for any purpose, such as the Administrative Procedure Act or the Freedom of Information Act.

The regular board would continue to make decisions for the target that are in the ordinary course of the target's business, and the regular board should seek the approval from the change of control board for any major decision, such as the sale or acquisition of a major line of business. The SEC should promulgate rules delineating the division of responsibilities between the two boards. Such rules will likely be similar to standard provisions found in acquisition agreements in which the target agrees that "[d]uring the period from the date of the agreement and continuing until the [closing of the acquisition]" it will "carry on [its] business in the usual, regular, and ordinary course" ³²⁴

This dual board structure is similar to but by no means the same as the dual board structure that applies to publicly held German corporations,³²⁵ which are required to have a management board and a supervisory board. The supervisory board appoints the management board and "plays a monitoring role somewhat similar to that played by outside directors on a unitary board."³²⁶ The supervisory board also has a role in "helping to develop the long-term corporate strategy and finance . . . ,"³²⁷ and "the articles of the supervisory board may determine that specific types of transactions may be entered into only with the approval of the supervisory board."³²⁸

2. *Compensation, Oversight, and Incentives For the Change of Control Board and Its Advisors*

Pursuant to Proposed Section 14A(g), the members of a change of control board are to be compensated by the target on

³²⁴ SAMUEL C. THOMPSON, JR. *BUSINESS PLANNING FOR MERGERS AND ACQUISITIONS* 777 (2d ed. 2001).

³²⁵ See, e.g., Thomas J. Andre, Jr., *Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards*, 70 TUL. L. REV. 1819 (1996). I understand from Professor Leo J. O'Brien that some religious organizations have a dual board structure.

³²⁶ *Id.* at 1824.

³²⁷ Theodor Baums, *Corporate Governance in Germany—System and Current Developments* 7 (2000) (unpublished paper).

³²⁸ Peter Behrens, *Background Information on German Company Law* 6 (Part II, OECD Project Revised Version, Jan. 1997).

a fee for services basis.³²⁹ The SEC is to promulgate rules concerning such compensation, including a periodically updated fee schedule.³³⁰ In developing these rules, the SEC is to take into consideration "such factors as the size of the parties, the complexity of the transaction and the level of fees that would be payable in the open market for comparable work for comparable companies."³³¹ It is crucial that in both perception and reality members of a change of control board be compensated fairly for their services. The Change of Control Official will be charged with monitoring each change of control board to ensure that the board does not unreasonably extend its term.³³² Further, the Change of Control Official is to develop methods and procedures for evaluating the performance of change of control boards for the purpose of determining whether members should be appointed to future change of control boards.³³³

The combination of the interesting—if not fascinating—work performed by a change of control board, the fair compensation afforded their members, and the potential for appointment to change of control boards in the future, should be powerful incentives for members of a change of control board to perform their services diligently. It could be expected that a vigorous market for membership on change of control boards would develop, and it could also be expected that the most challenging assignments would go to those who have been most effective in discharging their responsibilities.

The costs of operating a change of control board may indeed be less than the costs of having a regular board supervise an acquisition. This is true for two reasons. First, a change of control board will generally consist of just three members; therefore, the affected issuer will not incur the substantial meeting fees that would normally be paid to its much larger regular board for multiple meetings during the course of a change of control transaction. Second, the members of the change of control board normally will reside in the same geographic area in which the affected issuer has its headquarters, thereby minimizing travel costs.

³²⁹ See *infra* app. § 14A(g).

³³⁰ See *infra* app. § 14A(g).

³³¹ See *infra* app. § 14A(g).

³³² See *infra* app. § 14A(d)(2).

³³³ See *infra* app. § 14A(d)(2).

Proposed Section 14A(h)(1) sets forth a fee for service compensation arrangement for the advisers to the change of control board.³³⁴ However, under Proposed Section 14A(h)(2), in appropriate circumstances and with the approval of the Change of Control Official, investment bankers who add significant value to the transaction may be compensated on a contingent fee basis.³³⁵ The SEC is to promulgate rules setting out general guidelines concerning contingent fees.³³⁶

*E. Scope of Authority, Duty of Care,
and Business Judgment Rule*

Proposed Section 14A(i) sets out the rules regarding: (1) the scope of authority a change of control board has in a merger and acquisition transaction, (2) the duty of care governing actions taken by a change of control board, and (3) the business judgment rule protecting the change of control board.³³⁷ These provisions are based on the analogous provisions of the Corporate Governance Project.³³⁸ One standard applies to all types of mergers and acquisitions. The multiple rules set out in the Corporate Governance Project for different types of mergers and acquisitions are not needed because of the experience and disinterestedness of members of a change of control board.

Proposed Section 14A(i)(1), which sets out the general scope of authority specified in sections 6.01 (arm's-length transactions) and 6.02(a) (tender offers) of the Corporate Governance Project, provides that a change of control board may, in the exercise of its business judgment, approve, reject, or decline to consider a proposal to the target to engage in a merger or acquisition transaction and may take an action, such as the issuance of a poison pill, "that has the foreseeable effect of blocking an unsolicited tender offer."³³⁹

Proposed Section 14A(i)(2) authorizes the change of control board to consider the interests of constituencies other than shareholders with respect to which the target has a legitimate concern, if to do so would not significantly injure the long-term

³³⁴ See *infra* app. § 14A(h)(1).

³³⁵ See *infra* app. § 14A(h)(2).

³³⁶ See *infra* app. § 14A(h)(2).

³³⁷ See *infra* app. § 14A(i).

³³⁸ See *infra* app. § 14A(i), cmts. 1-5.

³³⁹ See *infra* app. § 14A(i)(1).

interest of shareholders.³⁴⁰ The same standard is set forth in section 6.02(b)(1) of the Corporate Governance Project.³⁴¹

The duty of care responsibility of the change of control board, which is based on Section 4.01(a) of the Corporate Governance Project is set out in Proposed Section 14A(i)(3).³⁴² Under this standard, each member of a change of control board has a duty to perform his or her duties (1) in good faith, (2) in a manner he or she reasonably believes is in the best interest of the corporation, and (3) with the care that a reasonably prudent person would exercise under similar circumstances.³⁴³ The director is required to make an inquiry when the circumstances would alert a reasonable director to the need for such an inquiry, and the extent of the inquiry is to be consistent with what "the director reasonably believes to be necessary."³⁴⁴ In discharging his or her functions, the director may rely on other persons in accordance with principles set forth in sections 4.02 and 4.03 of the Corporate Governance Project.³⁴⁵

The business judgment rule, which is set forth in Proposed Section 14A(i)(4), codifies the business judgment rule set forth in section 4.01(c) of the Corporate Governance Project.³⁴⁶ Under this standard, a member of a change of control board ful-

³⁴⁰ See *infra* app. § 14A(i)(2).

³⁴¹ See *infra* app. § 14A(i)(2) cmt. 1; CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02(b)(1). This standard might be viewed as basically consistent with the team production model of corporate law developed in Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporation Law*, 85 U. VA. L. REV. 247 (1999). In describing this model, the authors say:

the primary job of the board of directors of a public corporation is not to act as agents who ruthlessly pursue shareholders' interests at the expense of employees, creditors, or other team members. Rather, the directors are trustees for the corporation itself—mediating hierarchs whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.

Id. at 280-81; see also David Millon, *New Game Plan or Business As Usual? A Critique of the Team Production Model of Corporate Law*, 86 U. VA. L. REV. 1001 (2000).

³⁴² See *infra* app. § 14A(i)(3) cmt. 1; CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 4.01(a).

³⁴³ See *infra* app. § 14A(i)(3).

³⁴⁴ See *infra* app. § 14A(i)(3).

³⁴⁵ See *infra* app. § 14A(i)(3).

³⁴⁶ See *infra* app. § 14A(i)(4) cmt. 1; CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 4.01(c).

fills his or her duty under Proposed Section 14A(i)(4) as long as the following four conditions are satisfied:

- (1) the member must act in good faith.
- (2) the member must not be interested in the subject of the business judgment. Since the Change of Control Official is required to make an *ex ante* judgment that the member is not interested, it would be a truly rare case in which a court could find that the director is interested. Further, even if a court were to find that one of the directors of a change of control board was interested, as long as the other two directors voted in favor of the transaction and were not materially influenced by the disqualified director, the action of the board would be protected by the business judgment rule.
- (3) the member must be informed on the issue to the extent he or she reasonably believes to be appropriate under the circumstances. Since the Change of Control Official is required to make an *ex ante* determination that the member has sufficient experience in the merger and acquisition process, it would be a rare case in which this duty to make a proper inquiry would not be satisfied.
- (4) the member must rationally believe that his or her business judgment is in the best interest of the corporation. The only conceivable situations in which this condition would not be satisfied would involve fraud, mental incapacity, or some other similar reason, and in any event, a board's action would be protected by the business judgment rule as long as a majority of the directors approving the action is protected.³⁴⁷

Proposed Section 14A(i)(5) mirrors section 4.01(d) of the Corporate Governance Project by placing the burden of proof on the person challenging the transaction to establish a breach of the duty of care and the inapplicability of the business judgment rule.³⁴⁸ The challenging party must also establish that the breach was the legal cause of the damages suffered.³⁴⁹ Unlike section 4.01(d) of the Corporate Governance Project, which has a normal standard of proof, Proposed Section 14A(i)(5) adopts a clear and convincing standard of proof for

³⁴⁷ See *infra* app. § 14A(i)(4).

³⁴⁸ See *infra* app. § 14A(i)(5) cmt. 1; CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 4.01(d).

³⁴⁹ See *infra* app. § 14A(i)(5).

establishing the business judgment rule is inapplicable.³⁵⁰ Adoption of this more difficult burden is appropriate given the small chance that a change of control board would lose the benefit of the business judgment rule. This approach should substantially reduce litigation in the merger and acquisition process.

The duty of care and the business judgment rule apply to all types of mergers and acquisition transactions: arm's-length transactions, management buyouts, tender offers, and freezeouts.³⁵¹ Because of the experienced and conflict-free change of control board, there is no need for: (1) the enhanced business judgment standard set out in section 6.02 of the Corporate Governance Project for defensive tactics in tender offers; (2) the special market test rules of section 5.15 for management buyouts; or (3) the special rules of sections 5.10 and 7.25 for freezeouts.

F. No Personal Liability, Insurance, and Indemnification

Proposed Section 14A(j)(1) provides that, except in the case of a showing by clear and convincing evidence of fraud, a member of a change of control board has no personal liability.³⁵² This is consistent with director exculpation statutes such as section 102(b)(7) of the Delaware Business Corporation Law.³⁵³ Thus, any litigation involving the applicability of the business judgment rule will generally concern only the injunctive remedy.

Insurance and indemnification are provided for the members of a change of control board pursuant to Proposed Section 14A(j)(2).³⁵⁴ The SEC is to promulgate rules regarding insurance and indemnification,³⁵⁵ the cost of which will be borne by the target.

³⁵⁰ See *infra* app. § 14A(i)(5) cmt. 1; CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 4.01(d).

³⁵¹ See *infra* app. § 14A(b).

³⁵² See *infra* app. § 14A(j)(1).

³⁵³ See Delaware Business Corp. Law, Del. Code Ann. tit. 8, § 102(b)(7) (1991 & Supp. 2000).

³⁵⁴ See *infra* app. § 14A(j)(2).

³⁵⁵ See *infra* app. § 14A(j)(2).

G. Arbitration of Deadlocks in Majority Control Freezeouts

If a parent corporation proposes a freezeout transaction for a controlled subsidiary that is a public corporation, the subsidiary is an affected target. Consequently, a change of control board must be appointed for the subsidiary. Thus, in all such freezeout transactions, including short form mergers, a change of control board will first have to be appointed for the target-subsidary, unless the shareholders have elected out.

If a controlling parent has sufficient voting control of a controlled subsidiary to be able to unilaterally effectuate a freezeout transaction, the change of control board for the subsidiary should not be able to block the transaction indefinitely. For example, the change of control board should not be able to completely ignore the short form merger provisions of a state's corporation law. On the other hand, the change of control board should protect the subsidiary's minority shareholders from being forced by the controlling parent to sell their shares for inadequate consideration.

Initially, the change of control board may block the controlling parent from unilaterally completing a freezeout transaction. However, to break a deadlock between the subsidiary's change of control board and the controlling parent, Proposed Section 14A(k) provides that if these two parties cannot reach a decision on the price and other terms of such a freezeout, then the price and other terms are to be determined in a binding arbitration proceeding.³⁵⁶ The SEC is to promulgate rules governing both the point at which an arbitration proceeding is to begin and the procedures for such proceedings.³⁵⁷

H. Dissolution of the Change of Control Board

Under Proposed Section 14A(l), the change of control board is dissolved when the Change of Control Official grants a petition for dissolution.³⁵⁸ The petition is to be filed by the change of control board after the proposed merger or acquisition is either completed or abandoned.³⁵⁹ If the change of control

³⁵⁶ See *infra* app. § 14A(k).

³⁵⁷ See *infra* app. § 14A(k).

³⁵⁸ See *infra* app. § 14A(l).

³⁵⁹ See *infra* app. § 14A(1).

board does not timely file the petition, either the SEC or a 5% shareholder or shareholders may file the petition.³⁶⁰

I. Federal Jurisdiction and Preemption of State Law

Proposed Section 14A(m)(1) clarifies that any suits under the change of control provisions of Proposed Section 14A shall be brought in the appropriate federal district court, which generally will be the district court of the district in which the target has its headquarters.³⁶¹

Proposed Section 14A(m)(2) provides that the change of control provisions of Section 14A preempt all state statutes bearing on change of control transactions, such as control share statutes, business combination statutes, and disgorgement statutes.³⁶² In analyzing these laws, Professors Johnson and Millon have concluded, "[a]lthough often shrouded in the rhetoric of shareholder welfare, the primary goal of these laws is to protect various *non*-shareholder interests thought to be adversely affected by hostile takeover activity."³⁶³

Even though these laws are preempted here, the target's change of control board can, pursuant to Proposed Section 14A(i)(2), give consideration to the interest of groups other than shareholders, provided such consideration does not significantly disfavor the long-term interests of the target's shareholders.³⁶⁴

The preemption does not, however, extend to the normal provisions of corporate law governing shareholder voting on mergers and acquisitions.³⁶⁵ The SEC is to promulgate regulations specifying those state statutes that are preempted.³⁶⁶ Also, for the reasons outlined below, this provision preempts state appraisal statutes.

The preemption of state takeover statutes and of state appraisal statutes will greatly simplify the law governing mergers and acquisitions. Proposed Section 14A(m)(3) preempts all

³⁶⁰ See *infra* app. § 14A(1).

³⁶¹ See *infra* app. § 14A(m)(1).

³⁶² See *infra* app. § 14A(m)(2).

³⁶³ Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1863 (1989).

³⁶⁴ See *infra* app. § 14A(i)(2).

³⁶⁵ See *infra* app. § 14A(m)(3) cmt. 3.

³⁶⁶ See *infra* app. § 14A(m)(2).

corporate charter, by-law, or other contract provisions entered into by the target's regular board and bearing on mergers and acquisitions, including "golden parachute" arrangements, "poison pills," and lockups.³⁶⁷ This provision does not preempt normal charter and by-laws provisions governing shareholder voting on mergers and acquisitions.³⁶⁸ The SEC is to issue rules specifying those types of corporate provisions that are preempted.³⁶⁹

J. Elimination of Appraisal Remedy

Adoption of the change of control concept would eliminate the need for appraisal proceedings in transactions in which a change of control board has acted. Since the change of control board would, through arm's-length negotiations, determine the price to be paid in a merger and acquisition, one may presume that the price would be fair, thereby eliminating the need for an appraisal proceeding to determine a fair price. Consequently, the appraisal remedy should be eliminated for all transactions in which a change of control board is appointed, thus substantially simplifying the law governing mergers and acquisitions.³⁷⁰

Although this proposal may seem radical, it is consistent with the spirit of the Corporate Governance Project. In essence, the Corporate Governance Project provides that in each of the forms of acquisition in which appraisal rights are provided (*i.e.*, arm's-length mergers and acquisitions under section 6.01, management buyouts under section 5.15, and freezeouts under sections 5.10 and 7.25), a price negotiated on an arm's-length basis by disinterested directors is presumed to be a fair price under Section 7.22.³⁷¹

Further, there is a fundamental flaw with the structure of the appraisal remedy. If under current law or the Corporate Governance Project, appraisal is the exclusive remedy and the court in an appraisal proceeding determines that the fair price is higher than the transaction price, then by definition the

³⁶⁷ See *infra* app. § 14A(m)(3).

³⁶⁸ See *infra* app. § 14A(m)(3) cmt. 1.

³⁶⁹ See *infra* app. § 14A(m)(3).

³⁷⁰ See *infra* app. § 14A(m)(2) cmt. 1.

³⁷¹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.22 cmt. c.

acquisition price is less than fair. The only shareholders who receive the benefit of the fair price, however, are those shareholders who dissent and pursue their appraisal rights. The shareholders who do not dissent, generally most of the shareholders, are stuck with an unfair price.

Thus, there is a structural bias in the system for an acquiring corporation, particularly in management buyouts or freezeouts, to choose a less than fair price. As long as appraisal is the exclusive remedy, the only costs are: (1) the payment to the dissenters of the difference between the fair price and the transaction price, and (2) the litigation costs of the appraisal proceeding. The acquiring entity would have an economic incentive to pay less than fair value if the present value of the litigation costs is less than the difference between: (1) the aggregate fair price the non-dissenting shareholders would have received if they were all paid the fair price, and (2) the aggregate price they actually received. On the other hand, under the change of control concept, all of a target's shareholders will benefit from the "fair price" negotiated by the change of control board.

The structure of shareholder voting rights under both current law and the Corporate Governance Project may seem intuitively fair. Those shareholders that vote in favor of the merger get the benefit of the board's judgment. Those who dissent have the right to have their shares appraised. The appearance of fairness vanishes, however, when the practical aspects of shareholder voting are considered. Shareholders tend to vote with management even if the proposal is not in the best interest of the shareholders.³⁷² Professors Bradley and Schipani theorize that the reason for this is that "decrease in value of the stock [from voting with management] is less than the costs investors would have had to incur to prevent it."³⁷³ They go on to conclude:

[I]ndividuals will "produce" information up to the point where marginal costs equal marginal (expected) benefits. Under reasonable assumptions, individuals will "produce" a finite amount of information, which is to say they will decide to

³⁷² See Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 70-72 (1989).

³⁷³ *Id.* at 71.

remain rationally ignorant about some things. If voting with management increases shareholder wealth, "on average," then investors will find it uneconomical to investigate and weigh the merits of each proxy proposal. They will simply follow management's recommendation.³⁷⁴

As additional support for this proposition, the authors point out that, under modern portfolio theory, shareholders should own a diversified portfolio, and consequently, such shareholders "care little about the fortunes of any one firm."³⁷⁵

In a merger or acquisition where appraisal is the exclusive remedy, the acquiring firm can exploit the rational ignorance of shareholders at a price by paying fair value to only those few shareholders who incur the costs to acquire the information that leads them to dissent. The adoption of the change of control concept would protect rationally ignorant shareholders from exploitation and thereby enhance shareholder welfare.

K. Effective Date

Proposed Section 14A(n) provides that Proposed Section 14A is to become effective three months after the date of enactment.³⁷⁶ This should allow time for (1) the SEC to appoint a Change of Control Official or Officials and to promulgate rules under Proposed Section 14A, and (2) the Change of Control Official or Officials to prepare to perform their functions.

Upon the effective date of Proposed Section 14A, all executory contracts of the corporation bearing on change of control transactions, such as "golden parachutes" and "poison pills," will become null and void.³⁷⁷ Consideration should be given, however, to grandfathering provisions with respect to which there has been significant detrimental reliance.³⁷⁸

L. Effect on the Williams Act

The rules governing tender offers and open market purchases contained in the Williams Act, that is, sections 13(d),

³⁷⁴ *Id.*

³⁷⁵ *Id.*

³⁷⁶ *See infra* app. § 14A(n)(1).

³⁷⁷ *See infra* app. § 14A(n)(2).

³⁷⁸ *See infra* app. § 14A(n)(2) cmt. 1.

(e), and (f), and 14(d) and (e) of the 1934 Act,³⁷⁹ will remain in place with the following modifications.

Rule 13e-3³⁸⁰ and Schedule 13E-3³⁸¹ under the Securities Exchange Act of 1934 set forth rules governing going private transactions. These are transactions in which a controlling shareholder of a publicly-held corporation squeezes out the minority shareholders. Thus, the going private rules encompass all types of freezeout transactions. The rules are designed to promote fairness in such transactions by requiring, among other things, the controlling shareholder to explicitly state in its disclosure documents whether, in its view, the transaction is fair to the minority shareholders and to set forth in detail the basis for such a conclusion.³⁸² These rules can be burdensome, and compliance can be time consuming.

If the change of control board concept is adopted, a change of control board would be appointed for every going private transaction, unless the corporation has elected out of the change of control provision. If the going private transaction was the second step in a two-step acquisition, the change of control board for the target would have already been appointed for the first step, and that board would remain in place for the second step. If the freezeout were divorced in time from the acquisition of the initial controlling interest, as in *Weinberger*, a change of control board would be appointed specifically for the freezeout.³⁸³

A special rule would apply if the controlling shareholder has sufficient votes to effectuate the freezeout without the consent of the minority shareholders, and the change of control board and the controlling shareholder could not reach agreement on price within a reasonable period of time.³⁸⁴ In such case, the price and other significant terms would be determined by binding arbitration pursuant to rules promulgated by the SEC.³⁸⁵ Therefore, deadlocks would be prevented.

³⁷⁹ 15 U.S.C. §§ 78m(d)(e), 78n(d),(e) (1994).

³⁸⁰ 17 C.F.R. § 240.13e-3 (2000).

³⁸¹ 17 C.F.R. § 240.13e-100 (2000).

³⁸² 17 C.F.R. § 240.13e-3 (2000).

³⁸³ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 704-06 (Del. 1983).

³⁸⁴ *See infra* app. § 14A(k) cmt. 1.

³⁸⁵ *See infra* app. § 14A(k).

Under the change of control board concept, there is no need for rules such as Rule 13e-3 and Schedule 13E-3, because it can be presumed that the price negotiated by the change of control board or the price determined pursuant to arbitration would be fair to all of the minority shareholders. Consequently, it is proposed to exempt corporations that are subject to the change of control provision from the SEC's going private rules.

Rule 14e-1 requires that a tender offer remain open for 20 business days.³⁸⁶ To give the change of control board sufficient time to analyze the situation, Rule 14e-1 should be amended to provide that a tender offer is to remain open for 25 business days after the Change of Control Official certifies that a change of control board has been appointed.

Rule 14e-2 requires the target's board to take a public position on a tender offer within 10 business days of the commencement of the tender offer.³⁸⁷ As indicated above, this duty falls on the change of control board. To give the board adequate time to analyze the situation, Rule 14e-2 should be amended to extend the deadline to 15 business days after the Change of Control Official certifies that a change of control board has been appointed.

M. Inapplicability of Golden Parachute and Greenmail Provisions of the Internal Revenue Code

The Internal Revenue Code limits the deduction of certain golden parachute payments made by a target corporation to its management.³⁸⁸ Also, the Code imposes an excise tax on certain greenmail payments made by a target on the repurchase of target stock held by an unwanted shareholder.³⁸⁹ The purpose of these provisions is to curtail actions of a target's board that would likely result in members feathering their own nests or entrenching themselves.

Since the change of control board would be in control of the decision to make "golden parachute" and "greenmail payments," any such payments made by a target would not be for such

³⁸⁶ 17 C.F.R. § 240.14e-1(a) (2000).

³⁸⁷ 17 C.F.R. § 240.14e-2(a) (2000).

³⁸⁸ I.R.C. § 280G (1994). Also, an excise tax applies to the recipient of the golden parachute payment. See I.R.C. § 4999 (1986).

³⁸⁹ I.R.C. § 5881 (1994).

entrenchment purposes. Consequently, the "golden parachute" and "greenmail" provisions of the Code should not apply to corporations subject to the change of control provision.

N. Election-Out

Pursuant to Proposed Section 14A(o), the public shareholders of a corporation may elect not to have the change of control provisions or selected subsections of these provisions apply to the corporation.³⁹⁰ Thus, for example, the public shareholders of a corporation might elect to have the change of control provision apply in only the situation in which the corporation becomes a target of a hostile tender offer. I believe that few corporations will elect out, and therefore, the "election-out" rather than an "election-in" should be consistent with the "conventional approach to statutory defaults [which] is to choose what a majority of firms would adopt."³⁹¹

The procedures governing the operation of this election-out provision are to be specified by the SEC.³⁹² Such procedures are to be designed to ensure that the proposal for an election-out comes from public shareholders who have not been influenced by management or by a controlling shareholder and that the management and controlling shareholders in no way influence the vote on such a proposal.³⁹³

Thus, if independent public shareholders decide on their own initiative that it is in the best interest for the corporation to be free of this provision, they can vote to elect-out. In such a case, the current state and federal rules regarding mergers, acquisitions, and tender offers would apply to the elected-out corporation. The change of control concept is, therefore, a default provision. For the reasons discussed below, the only way to effectuate the change of control concept is to have federal preemption, with the possibility of an election out.

This election-out provision is very broad. Thus, even after a change of control board is appointed, a target's shareholders may, pursuant to regulations promulgated by the SEC, elect to remove the change of control board and thereby make the tar-

³⁹⁰ See *infra* app. § 14A(o).

³⁹¹ ROBERTA A. ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 84 (1992).

³⁹² See *infra* app. § 14A(o).

³⁹³ See *infra* app. § 14A(o) cmt. 1.

get subject to normal state and federal rules. As a consequence, if an acquiror has, for example, made an offer for the target at a substantial premium and the change of control board is "just saying no," the target's shareholders could elect to replace the change of control board with a normal board.

The presence of the election-out rule should prevent a domestic corporation from reincorporating as a foreign corporation to avoid Proposed Section 14A.

One commenter suggested that this change of control provision might be made mandatory with a sunset provision, such as automatic repeal after ten years, unless the provision is extended by Congress. It is suggested that this would permit a more accurate comparison of the empirical results of the change of control concept with such results under current law. I believe that it is preferable to allow shareholders to elect out of the provision if they choose; however, I would not object to having this concept subject to a sunset, unless extended.

O. Regulatory Exemption

Proposed Section 14A(p) gives the SEC the authority to exempt certain publicly-held corporations from this provision.³⁹⁴ The exemption may apply if, for example, a single individual or family owns a controlling block of shares or if the corporation has recently become public and the managers or organizers own a significant stock interest.³⁹⁵ This exemption should minimize the possibility that closely-held corporations will refuse to become public to avoid the application of Proposed Section 14A.³⁹⁶

P. Non-Bona Fide Offers

Proposed Section 14A(q) makes it illegal for a person to make a non-bona fide tender offer or a non-bona fide proposal to a target for the purpose of causing a trigger event to occur, thereby triggering the appointment of a change of control board.³⁹⁷ A non-bona fide offer or proposal is one in which the purported acquiror has no intent of completing the transaction.

³⁹⁴ See *infra* app. § 14A(p).

³⁹⁵ See *infra* app. § 14A(p) cmt. 1.

³⁹⁶ See *infra* app. § 14A(p) cmt. 1.

³⁹⁷ See *infra* app. § 14A(q).

This provision should deter parties from employing Proposed Section 14A for strategic purposes.³⁹⁸

Q. Number of Change of Control Boards That Would Have Been Appointed in 1995 and 1996 and Projection of Future Number of Change of Control Boards

An analysis of the SEC's report on its full disclosure reviews contained in its 1996 Annual Report³⁹⁹ provides a basis for estimating the approximate number of change of control boards that would likely be appointed each year. As indicated below, in view of the increase in the number of change of control transactions in recent years, the estimate based on the 1996 Report is adjusted upward.

In 1995, 140 tender offer statements were filed on Schedule 14D-1, 225 proxy statements were filed for mergers and "going private" transactions, 77 "going private" schedules were filed, and 59 contested proxy solicitations occurred. Likewise, in 1996, 165 tender offer statements were filed, 261 proxy statements for mergers and "going private" transactions were filed, 100 "going private" schedules were filed, and 62 proxy solicitations occurred. In each of these transactions, a change of control board would be appointed. In both 1995 and 1996, these schedules apparently did not involve a proxy statement but rather involved freezeout mergers in which the target's shareholders did not have the right to vote, but did receive a disclosure statement (*i.e.* an information statement) under section 14(c) of the 1934 Act.⁴⁰⁰

Change of control boards would also be appointed upon the filing of a Schedule 13D (which is required for acquisitions of more than 5% of the stock of a public issuer),⁴⁰¹ provided that the purpose of the acquisition is to effectuate a change of control of the issuer.⁴⁰² The SEC's Annual Report does not list the number of such filings, but it can be assumed that many are ultimately followed by the filing of a tender offer statement or a merger proxy statement, and thus would be automatically

³⁹⁸ See *infra* app. § 14A(q)(1).

³⁹⁹ 1996 S.E.C. ANN. REP. 79.

⁴⁰⁰ *Id.*

⁴⁰¹ 17 C.F.R. § 240.13d-101 (2000).

⁴⁰² See *infra* app. § 14A(b)(4).

counted with these documents. There certainly would be other transactions in which a Schedule 13D is filed, indicating a change of control purpose, but the Schedule 13D is not followed by the filing of either a tender offer statement or a merger proxy statement. It is difficult to estimate the number of such cases, but it would seem that an estimate of no more than 50 each year would be reasonable.

Thus, the estimated number of change of control boards that would likely have been required if this concept had applied in 1995 and 1996 would be as follows:

	1995	1996
[1] Tender Offers	140	165
[2] Mergers and Going Private Proxy Statements	225	261
[3] Going Private Schedules	77	100
[4] Contested Proxy Solicitation	59	62
[5] Schedule 13Ds for Change of Control Purpose, without a subsequent tender offer or merger (Estimated)	<u>50</u>	<u>50</u>
Estimated Number of Change of Control Boards	551	638

There has been an increase in the number of change of control transactions taking place since 1996, and it would not be unrealistic to assume that in some years 1000 change of control boards might be appointed. This assumes that none or very few corporations elected out of the provision.

Although this may seem like a large number of change of control boards, the above statistics demonstrate that there are a large number of change of control transactions taking place in our economy each year where the potential conflict between the directors and the shareholders may be preventing the maximization of shareholder value. The adoption of the change of control concept would eliminate these conflicts, maximize shareholder value, and significantly reduce the substantial litigation that arises in these transactions. Further, the SEC could appoint Change of Control Officials for various geograph-

ic areas, because the change of control boards would be spread throughout the country.

IV. ILLUSTRATION OF APPLICATION OF THE CHANGE OF CONTROL BOARD PROPOSAL IN SEVERAL SEMINAL TAKEOVER CASES

A. Introduction

This section discusses how the change of control board concept would likely have applied in the several seminal cases discussed above. In connection with arm's-length transactions, this section examines the potential impact of the change of control provision on the facts presented in (1) *Smith v. Van Gorkom*,⁴⁰³ (2) *Paramount Communications, Inc. v. Time Inc. (Time-Warner)*,⁴⁰⁴ and (3) *Paramount Communications, Inc. v. QVC Network, Inc.*⁴⁰⁵

For management buyouts, this section analyzes the impact of the change of control provision on the facts in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*⁴⁰⁶ and *Kahn v. Dairy Mart Convenience Stores, Inc.*⁴⁰⁷

In considering tender offers, this section examines the impact of this provision on the facts in (1) *Revlon, Inc. v. MacAndrews & Forbes Holdings*,⁴⁰⁸ (2) *Time-Warner*,⁴⁰⁹ (3) *QVC*,⁴¹⁰ (4) *Moore Corp. Inc. v. Wallace Computer Services, Inc.*,⁴¹¹ and (5) *Norfolk Southern Corp. v. Conrail, Inc.*⁴¹²

For freezeouts, this section examines the impact of the change of control provision on the facts in *Weinberger v. UOP, Inc.*⁴¹³ and *Kahn v. Lynch Communication Systems, Inc.*⁴¹⁴

⁴⁰³ 488 A.2d 858 (Del. 1985).

⁴⁰⁴ 571 A.2d 1140 (Del. 1989).

⁴⁰⁵ 637 A.2d 34 (Del. 1994).

⁴⁰⁶ 781 F.2d 264 (2d Cir. 1986).

⁴⁰⁷ Civ. A. No. 12489, 1996 WL 159628 (Del. Ch. Mar. 29, 1996), 21 DEL. J. CORP. L. 1143 (1996).

⁴⁰⁸ 506 A.2d 173 (Del. 1986).

⁴⁰⁹ 571 A.2d 1140 (Del. 1989).

⁴¹⁰ 637 A.2d 34 (Del. 1994).

⁴¹¹ 907 F. Supp. 1545 (D. Del. 1995)

⁴¹² No. 96-7167, 1997 U.S. Dist. LEXIS 978 (E.D. Pa. Jan. 9, 1987).

⁴¹³ 457 A.2d 701 (Del. 1983).

⁴¹⁴ 638 A.2d 1110 (Del. 1994).

B. Application of Change of Control Concept

Assuming the shareholders have not elected out under Section 14A(o), each of the target corporations in these ten cases (*i.e.*, Trans Union in *Van Gorkom*, SCM in *Hanson Trust*, Dairy Mart in *Dairy Mart Convenience Stores*, Revlon in *Revlon*, Time in *Time-Warner*, Paramount in *QVC*, Wallace in *Moore*, Conrail in *Norfolk Southern*, UOP in *Weinberger*, and Lynch in *Lynch Communications*) is a public corporation with respect to which a trigger event has occurred. Therefore, each of these targets is an "affected issuer" under Proposed Section 14A(a).⁴¹⁵

Consequently, under Proposed Section 14A(c)(1), the board of each of these targets is required to petition the Change of Control Official for the appointment of a change of control board.⁴¹⁶ Under Proposed Section 14A(e), the Change of Control Official must promptly appoint a change of control board, which normally will consist of three members, each of whom will have to be both qualified to serve on such a board and completely disinterested in the transaction.⁴¹⁷ Normally, one of the members will be appointed from the regular board, provided such person is otherwise qualified to serve.

Pursuant to Proposed Section 14A(f)(1), each of the change of control boards has complete authority over all matters relating to the proposed transaction.⁴¹⁸ Pursuant to Proposed Section 14A(f)(2), each change of control board would likely hire its own completely independent and conflict-free attorney and investment banker.⁴¹⁹ Pursuant to Proposed Section 14A(f)(4), each of the change of control boards would likely have extensive consultations with the regular boards concerning their views on the proposed transaction.⁴²⁰

Each of the change of control boards would be subject to the duty of care in Proposed Section 14A(i)(3) and the business judgment rule in Proposed Section 14A(i)(4).⁴²¹ This is the case without respect to the form of the transaction, that is,

⁴¹⁵ See *infra* app. § 14A(a)-(b).

⁴¹⁶ See *infra* app. § 14A(c)(1).

⁴¹⁷ See *infra* app. § 14A(e).

⁴¹⁸ See *infra* app. § 14A(f)(1).

⁴¹⁹ See *infra* app. § 14A(f)(2).

⁴²⁰ See *infra* app. § 14A(f)(4).

⁴²¹ See *infra* app. § 14A(i)(3)-(4).

negotiated merger, management buyout, tender offer, or freezeout merger. In each of the situations it can be expected that the change of control board would clearly satisfy its duty of care obligation and would clearly receive the benefit of the business judgment rule. Pursuant to Proposed Section 14A(j)(1), absent fraud, no member of the change of control board would face liability.⁴²²

Pursuant to Proposed Section 14A(m), any suits dealing with the change of control board must be brought in the appropriate federal district court.⁴²³ Also, under this section, the change of control provisions preempt state law statutes bearing on change of control transactions,⁴²⁴ such as Pennsylvania's takeover law, which is very protective of a target's management and was at issue in *Norfolk Southern*,⁴²⁵ and Delaware's business combination statute, which in certain circumstances prevents a hostile acquiror from effectuating a second step freezeout transactions.⁴²⁶ However, because of the protection afforded by the business judgment rule, it is highly unlikely that there would be litigation involving the change of control boards in any of these cases.

Turning to the facts of the cases illustrating arm's-length transactions, the change of control board for Trans Union would have decided what steps should be taken in attempting to sell Trans Union, and there certainly would not have been a quick deal with Jay Pritzker. Also, the change of control boards for Time and Paramount would likely have not entered into the original merger agreements with Warner and Viacom, without first undertaking a careful market test. The impact of the change of control provisions on Time and Paramount in connection with the tender offer aspect of these cases is examined further below.

Turning to management buyouts, the change of control board for SCM clearly would not have granted Merrill Lynch and the management group the option on SCM's crown jewels without getting an opinion from the investment banker on the

⁴²² See *infra* app. § 14A(j)(1).

⁴²³ See *infra* app. § 14A(m)(1).

⁴²⁴ See *infra* app. § 14A(m)(2).

⁴²⁵ 15 PA. CONST. STAT. ANN. § 2544 (1995).

⁴²⁶ Delaware Business Corporation Law, DEL. CODE ANN. tit. 8, § 203 (1991 & Supp. 2000).

value of the optioned assets. Also, the change of control board for Dairy Mart would not have been under the control of the controlling shareholder, and, therefore, would have actively sought alternative offers.

In connection with the tender offer transactions, the change of control board for Revlon would not have extended the auction-ending lockup to Forstmann, but would have ensured that Revlon went to the highest bidder.

Even if the change of control board for Time had entered into a merger agreement with Warner, the board likely would have given the Time shareholders the opportunity to choose whether to tender to Paramount, particularly after Paramount raised its price to \$200 per share. Time's board was likely misled by an overly optimistic valuation of Time provided by the board's investment banker, Wasserstein Perella. Wasserstein may have had a strong incentive to see the Time-Warner transaction proceed. This would not have been the case with an investment banker for Time's change of control board.

Thus, the result with a change of control board in *Time-Warner* likely would have been significantly different from the result flowing from the court's decision. After taking account of a stock split that Time-Warner effectuated, Paramount's \$200 offer in 1989 translates into an offer of \$50 per share in 1999. The price of Time-Warner's shares did not reach the level of Paramount's 1989 offer until 1997. Wasserstein's prediction was that these shares, taking account of the split, would be trading in 1993 in a range of \$92 to \$100.50.⁴²⁷ There can be no doubt that Time's shareholders would have been much better off if they could have accepted the Paramount offer.

The change of control board for Paramount in *QVC* likely would not have entered into the merger agreement with Viacom without exploring thoroughly and openly a transaction with QVC, which was very interested in making a competing bid. The likely effect of such an exploration would have been an auction of Paramount to the highest bidder, which was the effect of the court's decision.

The only reason that Paramount was ultimately sold to Viacom pursuant to the auction for \$110 per share, when the

⁴²⁷ See Reed Abelson, *When Boards Say 'No Deal' to Holders*, N.Y. TIMES, Oct. 6, 1996, at C1.

original merger price was only \$70 per share, was the presence of QVC, which was willing to become a hostile bidder. If QVC had not been willing to make a bid, it is likely that there would not have been an auction, and Paramount's shareholders would have received the \$70 per share set out in the original merger agreement. Under the circumstances in *QVC*, even if QVC had not been interested, it is highly unlikely that Paramount's change of control board would have entered the merger agreement with Viacom without first canvassing the market for other potential purchasers. Thus, even if QVC were not already interested in making an offer for Paramount, the change of control board might have induced QVC to make such an offer.

The change of control board for Wallace may or may not have made a decision to keep the pill in place and reject Moore's offer. The decision would have depended upon the assessment by the change of control board of the expected value of Wallace after consulting with the independent investment bankers for the change of control board. It is likely that the investment bankers for the change of control board would be more direct than Goldman Sachs seems to have been in dealing with Wallace's board.

In the *Conrail* transaction, Proposed Section 14A(m)(2) would have preempted Pennsylvania's takeover laws, and, therefore, the *Conrail* change of control board would have been subject to the standard duty of care and the business judgment rule.⁴²⁸ It is highly unlikely that *Conrail*'s change of control board would have rejected the Norfolk offer in favor of CSX's lower offer. The end result of a division of *Conrail* between CSX and Norfolk Southern may have also occurred with a change of control board, but this result could have been reached without lengthy and costly litigation.

Turning to freezeouts, the change of control board for UOP would have had meaningful negotiations with Signal concerning an appropriate price to be paid in the freezeout merger. If the parties could not have reached an agreement, then under Proposed Section 14A(k), the price and other terms of the transaction would have been determined by arbitration.⁴²⁹ A

⁴²⁸ See *infra* app. §§ 14A(m)(2), (i)(3)-(4).

⁴²⁹ See *infra* app. § 14A(k).

similar result would have been reached under the facts in *Lynch Communications*.

The change of control board in each of these cases would have addressed the inherent conflicts of interest faced by the targets' directors.

In summary, the actions taken by a change of control board would likely have produced the same results as those reached by the courts in *Van Gorkom*, *Hanson Trust*, *Dairy Mart*, *Revlon*, *QVC*, *Weinberger*, and *Lynch*. On the other hand, in *Time-Warner*, *Moore*, and *Norfolk Southern*, a change of control board likely would have reached a different result than that reached by the courts. In all these cases, the change of control boards would have been much more protective of the interest of the targets' shareholders than were the targets' boards, and in each case it is unlikely that there would have been litigation concerning actions taken by the change of control board.

V. WHY NOT USE DISINTERESTED DIRECTORS UNDER EXISTING LAW?

An obvious question is presented by the proposal for a change of control board: Why not simply rely on disinterested directors under current law to perform the functions of the change of control board? The Corporate Governance Project adopts the disinterested director concept in dealing with management buyouts under section 5.15,⁴³⁰ non-majority control freezeouts under section 5.10,⁴³¹ and majority control freezeouts under section 7.25.⁴³² Also, the Corporate Governance Project indicates that in the context of defensive tactics governed by section 6.02, interested directors who participate in a decision should not be held financially liable if the "number of disinterested directors who approve [the defensive action] is *legally* sufficient to authorize action of the corporation"⁴³³

⁴³⁰ CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 5.15.

⁴³¹ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 5.10.

⁴³² See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 7.25.

⁴³³ CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 6.02 cmt. a (emphasis added).

In addition, section 3A.01 of the Corporate Governance Project recommends that every large publicly-held corporation have a majority of independent directors.⁴³⁴ Similarly, the Committee on Corporate Laws of the American Bar Association suggests in its Corporate Director's Guidebook that "at least a majority of members of the boards of publicly-held corporations should be independent of management."⁴³⁵ Further, the Business Roundtable, in its *Statement on Corporate Governance*, suggests that a "substantial majority of the directors of [a large publicly owned] corporation should be outside (non-management) directors."⁴³⁶ Also, Martin Lipton and Jay Lorsch have suggested that public corporations should have a "ratio of at least two independent directors to any director who has a connection with the company, either as management or substantial customer or supplier of goods or services."⁴³⁷

There is also empirical evidence that the presence of independent directors on a board can benefit the shareholders of a target company. One study has found that the shareholders of a corporation that issues a poison pill are likely to experience positive abnormal stock returns upon the announcement of the adoption of the pill if the board of the corporation consists of a majority of outside directors.⁴³⁸ On the other hand, the abnormal returns were negative if less than a majority of the board consisted of outside directors. Abnormal returns are those falling either above (*i.e.* positive) or below (*i.e.*, negative) what would be predicted by normal market moves. The computation of abnormal returns, which is performed through what is referred to as an event study, is a statistical measure of the effect a particular event has on a corporation's share price.

⁴³⁴ See CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 3A.01.

⁴³⁵ COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASS'N, CORPORATE DIRECTOR'S GUIDEBOOK 16 (2d ed. 1994) [hereinafter CORPORATE DIRECTOR'S GUIDEBOOK].

⁴³⁶ THE BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE, 10 (Sept. 1997).

⁴³⁷ Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 67 (1992).

⁴³⁸ James A. Brickley et al., *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371, 387-89 (1994) (discussing this article and similar articles); see also Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 930-937 (1996).

Furthermore, it has been found that in management buyouts of publicly-held firms the cumulative abnormal returns of the target's shareholders are substantially higher when the target's board consists of a majority of independent directors.⁴³⁹ There is also evidence that the wealth effects on the shareholders of acquiring firms are likely to be more favorable when independent directors comprise at least half of the acquiror's board.⁴⁴⁰

In a recent study of the impact of disinterested directors on corporate performance, Professors Bhagat and Black conclude that "[t]aken as a whole, the studies of the role of the target company's board in an acquisition provide evidence that majority-independent boards extract higher prices from bidders."⁴⁴¹ However, with regard to takeover defenses, they conclude that "there is little evidence that relatively independent boards behave in a significantly more (or less) shareholder-friendlier fashion than other boards when they adopt and employ takeover defenses."⁴⁴²

In addressing the relationship between board composition and general firm performance, Professors Bhagat and Black have found that "there is no convincing evidence that *increasing* board independence, relative to the norms that currently prevail among large American firms, will improve firm performance."⁴⁴³ Similarly, Professor Lin has found that the empirical evidence is "mixed regarding whether the proportion of outside directors has a positive effect on overall firm performance."⁴⁴⁴ However, Ira Millstein, a leading corporate practi-

⁴³⁹ Chun I. Lee et al., *Board Composition and Shareholder Wealth: The Case of Management Buyouts*, 21 FIN. MGMT. 58, 58 (1992); see also Lin, *supra* note 438, at 930-31.

⁴⁴⁰ John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195, 207 (1992). See also Lin, *supra* note 438, at 930-31.

⁴⁴¹ Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 928 (1999).

⁴⁴² *Id.* at 930.

⁴⁴³ *Id.* at 950.

⁴⁴⁴ Lin, *supra* note 438, at 962. For a proposal that public companies be required to disclose "(1) whether or not there is a separate independent chair, and if there is not, (2) whether or not its board of directors has designated a senior independent director who functions as a leader of its independent directors," see Constance E. Bagley & Richard H. Koppes, *Leader of the Pack: A Proposal for Disclosure of Board Leadership Structure*, 34 SAN DIEGO L. REV. 149, 152 (1997).

tioner, and Professor Paul W. MacAvoy in a 1998 study found "a statistically significant relationship between an active, independent board and superior corporate performance as measured by earnings in excess of costs of capital over the industry average."⁴⁴⁵ They go on to conclude that "[C]orporations that received an 'A+' CalPERS corporate governance grade and corporations that graded as having active governance 'present' both performed significantly better in generating earnings in the 1990s than did the other corporations in the sample of large domestic corporations."⁴⁴⁶

Notwithstanding these divergent findings on general performance, there seems to be strong empirical evidence to the effect that independent directors benefit shareholders in various acquisition contexts. Thus, it seems clear that action by disinterested directors in the merger and acquisition context is preferable to action taken by interested directors. However, in the words of former Chancellor Allen of the Delaware Court of Chancery, "the jury is still out on the question whether the special committee device [that is, disinterested directors] works well enough, often enough, for the law to continue to accord it weight."⁴⁴⁷ The proposal here for a change of control board is designed to ensure that the directors acting for the target in a change of control situation are truly disinterested and knowledgeable.

Chancellor Allen's skeptical view of the true independence of disinterested directors also has been expressed by two prominent judges on the Seventh Circuit: Judge Richard Posner, a vigorous supporter of an economic approach to the law, and Judge Cudahy, who apparently is not a disciple of the law and economics movement.

The authors say that the findings of the Bhagat and Black study suggest that "American corporations need to do more than just place independent directors on their boards to increase shareholder wealth via their corporate governance activities." *Id.* at 161.

⁴⁴⁵ Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1318 (1998).

⁴⁴⁶ *Id.*

⁴⁴⁷ William T. Allen, *Independent Directors In MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2062-63 (1990). For a discussion of some of the practical aspects of using independent directors for special transactions, see A. Gilchrist Sparks, III & Mark Hurd, *Special Negotiating Committees*, 30 REV. SEC. & COMMODITIES REG. 97 (Apr. 23, 1997).

In his dissenting opinion in *Panter v. Marshall Field & Co.*,⁴⁴⁸ which was decided before *Unocal Corp. v. Mesa Petroleum Co.*,⁴⁴⁹ Judge Cudahy criticizes the majority for applying Delaware's normal business judgment rule in examining a board's defensive tactics.⁴⁵⁰ He points out that the "theoretical justification for the 'hands off' precept of the business judgment rule is that courts should be reluctant to review the acts of directors in situations where the expertise of the directors is likely to be greater than that of the courts."⁴⁵¹ He adds, however, that if the directors are afflicted with a conflict of interest, relative expertise is no longer crucial, and, in such cases, "courts have no rational choice but to subject challenged conduct of directors . . . to their own disinterested scrutiny."⁴⁵²

Judge Cudahy then says that the *Panter* majority relies heavily on the business judgment rule in presuming good faith on the part of the directors and "attaches special significance to the 'independence' of Field's [*i.e.*, the target's] Board."⁴⁵³ He then challenges the assumption that Field's Board is independent:

The fact that Field's may have had a majority of non-management (independent) directors is hardly dispositive. The interaction between management and board may be very strong even where, as here, a relationship of symbiosis seems to prevail over the normal condition of "management domination." Whether the relationship is symbiotic or management "dominates," I do not think it necessary to rely primarily on . . . [direct] pecuniary relationships . . . to establish a conflict of interests here. . . . [T]he very idea that, if we cannot trace with precision a mighty flow of dollars into the pockets of each of the outside directors, these directors are necessarily disinterested arbiters of the stockholders' destiny, is appallingly naive.⁴⁵⁴

⁴⁴⁸ 646 F.2d 271, 299 (7th Cir. 1981) (Cudahy, J., concurring and dissenting).

⁴⁴⁹ 493 A.2d 946 (Del. 1985).

⁴⁵⁰ *Panter*, 646 F.2d at 299-312 (Cudahy, J., concurring and dissenting).

⁴⁵¹ *Id.* at 300 (Cudahy, J., concurring and dissenting).

⁴⁵² *Id.* (Cudahy, J., concurring and dissenting).

⁴⁵³ *Id.*

⁴⁵⁴ *Id.*

Judge Cudahy then goes on to catalogue how independent directors are in his view interested:

Directors of a New York Stock Exchange-listed company are, at the very least, "interested" in their own positions of power, prestige and prominence (and in their not inconsequential perquisites). They are "interested" in defending against outside attack the management which they have, in fact, installed or maintained in power, "their" management (to which, in many cases, they owe their directorships). And they are "interested" in maintaining the public reputation of their own leadership and stewardship against the claims of "raiders". . . .⁴⁵⁵

The types of "interests" identified by Judge Cudahy are not cognizable interests under current law or under the Corporate Governance Project. Section 1.23 of the Corporate Governance Project provides that a director is interested in the transaction if the director: (1) is a party to the transaction; (2) has a business, financial or [family] relationship with a party and the relationship could reasonably be expected to adversely affect the director's judgment; (3) has a direct or indirect material pecuniary interest in the transaction (other than normal director's fees and benefits) and the interest could reasonably be expected to adversely affect the director's judgment; or (4) is under the control of a party to the transaction or one who has a material pecuniary interest in the transaction and such control could reasonably be expected to adversely affect the director's judgment.⁴⁵⁶

Judge Posner's assessment of the independence of outside directors seems to be in complete agreement with that of Judge Cudahy. In *Dynamics Corp. v. CTS Corp.*,⁴⁵⁷ Judge Posner, in finding that the target's board had violated its fiduciary duty in issuing a poison pill, stated:

When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of

⁴⁵⁵ *Id.* at 300-01.

⁴⁵⁶ CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 1.23.

⁴⁵⁷ 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority No one likes to be fired, whether he is just a director or also an officer. The so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of insiders, to whom they are likely therefore to defer.⁴⁵⁸

These observations by Judges Cudahy and Posner in the context of an examination of a board's defensive action are consistent with Chancellor Allen's examination of the role of independent directors in management buyouts. The Chancellor points out that there are some cases, like *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,⁴⁵⁹ that support the cynical view that independent boards do not properly function; and there are other cases, such as *In re RJR Nabisco Shareholders Litigation*,⁴⁶⁰ in which the independent directors appeared to be "energetically exercising informed and independent judgment in the sale of the enterprise."⁴⁶¹ The Chancellor goes on to summarize the Delaware cases as follows: "[I]n the sale context, the Delaware cases suggested that it is possible for 'outside' directors to function independently But those cases demonstrate as well that not every decision by an apparently disinterested special committee deserves or will be accorded that respect."⁴⁶² Notwithstanding the bright spots, he "confess[es] a painful awareness of the ways in which the device may be subverted and rendered less than useful."⁴⁶³

The Chancellor also observes that outside directors who serve on a special committee to preside over the sale of a company have a "fairly unappetizing assignment" because "no matter what the director does he will probably be sued for it."⁴⁶⁴ He further points out that outside directors have a tendency to

⁴⁵⁸ *Dynamics*, 794 F.2d at 256.

⁴⁵⁹ 781 F.2d 264 (2d Cir. 1986).

⁴⁶⁰ [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94, 194 (Del. Ch. 1989).

⁴⁶¹ Allen, *supra* note 447, at 2060.

⁴⁶² *Id.*

⁴⁶³ *Id.* at 2056.

⁴⁶⁴ *Id.* at 2061.

rely on their advisers because "[f]requently, the outside directors who find themselves in control of a corporate sale process have little or no experience in the sale of a public company. They are in *terra cognita*."⁴⁶⁵ Thus, there is not only the problem with the potential conflict of interest, but also with inexperienced outside directors. This problem can lead to passivity of the type manifested by the independent board members in *Smith v. Van Gorkom*,⁴⁶⁶ which involved an arm's-length transaction, and in *Weinberger v. UOP, Inc.*,⁴⁶⁷ which involved a freezeout.

Thus, there are cases dealing with each of the types of mergers and acquisitions addressed here (that is, arm's-length mergers and acquisitions, management buyouts, tender offers, and freezeouts) in which independent board members have failed to act in the best interest of the shareholders. Further, even if their actions appear on their face to be proper, there is always the reality that independent directors will conduct themselves with a view toward litigation and in ways which may "obscure their true motives."⁴⁶⁸

The change of control board concept addresses directly both the conflict problem and the inexperience problem identified by Chancellor Allen and also the passivity problems illustrated in *Van Gorkom* and *Weinberger*. The Change of Control Official must make an *ex ante* judgment that each appointee to a change of control board has both (1) no conflict of interest of the type outlined above by Judge Cudahy or set forth in section 1.23 of the Corporate Governance Project, and (2) the requisite experience to address the issues presented by the proposed change of control transaction. It can, therefore, be expected that change of control boards would aggressively pursue the best interest of the corporation and the shareholders without respect to the type of transaction or the identity of the parties.

Most of the boards of the target companies in the seminal cases examined above had a majority of disinterested directors, and in each of those cases the boards appear not to have acted in the best interest of the target's shareholders. While this does

⁴⁶⁵ *Id.*

⁴⁶⁶ 488 A.2d 858 (Del. 1985).

⁴⁶⁷ 457 A.2d 701 (Del. 1983).

⁴⁶⁸ Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 281 (1977).

not show that disinterested directors never work properly in the merger and acquisition context, it does show that there are many situations in which the performance of disinterested directors is not optimal.

Finally, while it can be expected that a change of control board would act in the interest of the target's shareholders and thereby ensure that they are treated fairly, Professors Bhagat and Black, among others, have argued that the "[h]igher premia [resulting from the use of disinterested directors] are not unequivocally good"⁴⁶⁹ They elaborate as follows:

If both bidder and target are publicly traded, a higher takeover price is simply a wealth transfer from the bidder's shareholders to the target's shareholders. Moreover, if shareholders are diversified, then over a number of transactions, the bidder's shareholders and the target's shareholders *are the same people*. The key to economic efficiency in the takeover market is not the price paid by the acquirer, but instead: (i) whether there is a good strategic fit between the acquirer and the target (for which a good measure is combined bidder and target returns, not target returns alone); and (ii) whether there is an optimal frequency of takeovers, taking into account both their efficiency benefits and transaction costs.⁴⁷⁰

This line of reasoning suggests that a diversified investor should prefer takeover governance rules that promote the "optimal frequency of takeovers." But, it is impossible to know the "optimal frequency of takeovers." Further, not all investors are diversified, and it can be expected that virtually all investors in a target will want very much to be paid a fair price for their shares. Moreover, if for whatever reason, investors feel that the change of control concept is not in their interest, they can elect out of the provision.

One final point on the "optimal frequency of takeovers" is that the current rules in Delaware and in many other states give a target's directors wide latitude in defending against unwanted takeovers. These rules may, therefore, have the effect of deterring takeovers because acquirors may not want to incur the expense and time needed to overcome a recalcitrant

⁴⁶⁹ Bhagat & Black, *supra* note 441, at 926.

⁴⁷⁰ *Id.*

management. This should not be the case with a change of control board because such a board will not erect artificial barriers to the completion of an acquisition, and even if a change of control board were to erect artificial barriers, the target's shareholders could, pursuant to SEC rules, vote to eliminate the change of control board. Thus, as compared with present law, the adoption of the change of control concept may move the merger and acquisition market place in the direction of the "optimal frequency of takeovers."

Finally, one commenter suggested that if the change of control board concept were more efficient than current law, it could be expected that companies issuing shares in initial public offerings would include similar provisions requiring action by disinterested directors in their charters, assuming it would be legal for them to do so. It appears, however, that IPO companies are moving in the opposite direction by including measures in their charters that can help deter takeovers, such as staggered boards.⁴⁷¹

VI. WHY A FEDERALLY MANDATED CHANGE OF CONTROL BOARD

A. Introduction

There is nothing to prevent a state legislature from enacting a provision that mandates a change of control board. However, the "[t]wo interest groups [that] have dominated the development of American corporate law—[the] corporate lawyers and corporate managers. . . ."⁴⁷² would likely be able to block the enactment of any such legislation. And, in any event, state legislative action in adopting such a requirement could be avoided by merely reincorporating the corporation in a state that did not have such a provision. Also, it is unrealistic to think that many corporations would voluntarily include such a

⁴⁷¹ Coates, *Takeover Defenses*, *supra* note 298, at 277.

⁴⁷² William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 306 (1997) [hereinafter Carney, *Competition for Corporate Charters*]. See generally William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998) (explaining role of interest groups in corporate law production); Jonathan R. Macey & Geoffrey P. Miller, *Toward An Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (explaining evolution of Delaware's corporate law from "race to the bottom" and "corporate federal" theories to "interest group" theory).

provision in their articles (assuming it would be permissible to do so), because the current board has control over the proxy process and shareholder proposals do not tend to succeed. As explained by Professors Bradley and Schipani, shareholders tend to vote with management because they "find it uneconomical to investigate and weigh the merits of each proxy proposal."⁴⁷³

Thus, the only practical avenue for making the change of control board effective for publicly-held corporations is to have a federally mandated provision that applies uniformly to all registered corporations. Further, this approach is, basically consistent with the approach Congress took with the enactment of the Securities Litigation Uniform Standards Act of 1998, which makes federal court the exclusive venue for most securities fraud class action [litigation] involving nationally traded securities.⁴⁷⁴ In fact, the change of control concept is arguably not as dramatic a change as that enacted by the Securities Litigation Uniform Standards Act of 1998 because corporations can opt-out of the change of control provision.

It can be anticipated that many will object to the need for this type of federal rule. For example, Professor Fischel has argued that there is no "convincing theoretical case" and no empirical evidence supporting the view that a majority of independent directors will increase shareholder welfare.⁴⁷⁵ Although the empirical evidence on the issue of whether independent directors have an effect on overall firm performance is "mixed,"⁴⁷⁶ there is evidence that the presence of independent directors in various merger and acquisition contexts can have a positive effect on shareholder welfare.⁴⁷⁷ This proposal goes one step further by insuring that in a change of control trans-

⁴⁷³ Bradley & Schipani, *supra* note 372, at 71.

⁴⁷⁴ See Joint Explanatory Statement of the Committee of Conference, 144 CONG. REC. H10774, H10774 (Oct. 13, 1998). See Securities Exchange Act of 1934 § 28(f), 15 U.S.C. §§ 78c, 78l (1994). See generally Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215 (1999) (discussing expansion of federal regulation of corporations with enactment of Securities Litigation Uniform Standards Act of 1998).

⁴⁷⁵ Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1283 (1982).

⁴⁷⁶ Lin, *supra* note 438, at 962.

⁴⁷⁷ *Id.* at 930-37.

action, the target has a change of control board that is unquestionably independent and also knowledgeable in addressing change of control issues.

In arguing against the change of control board, some might endorse the argument of Professor Fischel that it is preferable to "allow private parties to organize in whatever manner they wish,"⁴⁷⁸ because if the change of control board concept "really will increase shareholders' welfare, it will be undertaken voluntarily. . . ."⁴⁷⁹ But for reasons noted above, it is highly unlikely that a state would enact a change of control provision because companies would likely reincorporate to avoid the provision. Thus, as a practical matter the federal route is the only viable option. Furthermore, since there is an elect-out provision, the change of control concept is merely a default rule, and if it is inefficient companies could be expected to elect-out. My guess, however, is that there would be few elections out. If I am completely wrong and all corporations elect out, then there is merely a return to the status quo, and it would thereby be demonstrated, by a fairly costless election out procedure, that the status quo maximizes shareholder welfare. On the other hand, if I am right, the enactment of this provision could substantially enhance shareholder welfare.

Professor Fischel has criticized Professor Cary's proposal for federally mandated minimum corporate standards as being "contradicted by all available theoretical and empirical evidence,"⁴⁸⁰ and it can be expected that this proposal will be criticized on similar grounds. Also, criticism along similar lines can be expected from the Delaware corporate bar. For these reasons, this section examines the empirical case for a federally mandated change of control board.

B. Comparison of This Proposal With Federalization Proposals of Professor Cary and Others

Professor Cary has argued that Delaware's legislature and courts in an effort to attract corporations to that state have

⁴⁷⁸ Fischel, *supra* note 475, at 1284.

⁴⁷⁹ *Id.*

⁴⁸⁰ Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 921 (1982) [hereinafter Fischel, *Race to the Bottom*].

engaged in a "race to the bottom" by not providing adequate protection of shareholders' rights.⁴⁸¹ He, therefore, argues that federal standards of corporate responsibility should be enacted. Specifically, he has proposed "minimum corporation law provisions which shall be applicable to companies doing business in interstate commerce and construed by federal judicial standards."⁴⁸² His proposal is for a Federal Corporate Uniformity Act that would apply to all corporations having more than \$1 million in assets and 300 shareholders.⁴⁸³ Although these companies would still incorporate in the jurisdictions of their choice, they would be subject to federal rules governing such items as: (1) fiduciary standards, (2) interested directors, (3) issuance of nonvoting shares, and (4) indemnification of directors.⁴⁸⁴

Others have made similar proposals, including Professor Schwartz, who argues that Professor Cary's minimum standards approach does not go far enough and that a federal chartering law should be adopted "applying federal standards consistently to all facets of corporation law."⁴⁸⁵

Bills were introduced in 1980 that would have significantly increased the federal regulation of corporations.⁴⁸⁶ These bills were not enacted, however.

Also, in a 1992 article Professor Bebchuk argues that "state competition may well produce socially undesirable results whenever a corporate law issue involves significant externalities."⁴⁸⁷ He suggests that "it may well be desirable to adopt federal law rules—or at least federal minimum standards—with respect to [issues involving]" significant externalities such as the regulation of takeovers and proxy

⁴⁸¹ William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700-01 (1974).

⁴⁸² *Id.* at 701.

⁴⁸³ *Id.*

⁴⁸⁴ *Id.* at 702

⁴⁸⁵ Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125, 1139 (1976). See also RALPH NADER, MARK GREEN & JOEL SELIGMAN, *CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS* (1976) (stating that it is constitutional for federal government to charter business).

⁴⁸⁶ See Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong. (1980); Corporate Democracy Act of 1980, H.R. 7010, 96th Cong. (1980).

⁴⁸⁷ Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1494 (1992).

contests, the protection of creditors, disclosure regulation, and the protection of constituencies other than providers of capital.⁴⁸⁸

The proposal here for a federal rule mandating a change of control board does not go nearly as far as these prior federal proposals. The proposal here is focused on transactions in which there is compelling evidence that boards, even if acting through independent directors, are not performing in a manner that maximizes shareholder welfare. Further, the proposal here is only a default rule; shareholders can elect not to have the provision apply or can elect to have the provision only apply in certain circumstances, such as hostile tender offers. Thus, the approach increases the competition for corporate governance rules.

C. Criticisms of the Cary Approach

1. The Basic Criticism

In 1985, Professor Fischel in a criticism of the Delaware Supreme Court's decision in the *Smith v. Van Gorkom*⁴⁸⁹ case wrote:

Delaware corporate law has had its critics, most significantly Professor William Cary, who wrote a famous article attacking Delaware a decade ago [referring to Cary, *Federalism*]. But today, Cary's position has been discredited; indeed, in recent years it has been discussed only as an illustration of *how it is possible to reach the wrong conclusions if one lacks a basic understanding of the economic structure of the corporation and of corporate law*.⁴⁹⁰ (emphasis added).

This harsh indictment of Professor Cary's position was first set out by Professor Fischel in a 1982 article in which he argued that Delaware was successful in attracting corporations because its corporate law represented a "climb to the top," not a "race to the bottom."⁴⁹¹ He asserts that "all available theo-

⁴⁸⁸ *Id.* at 1495.

⁴⁸⁹ 488 A.2d 858 (Del. 1983).

⁴⁹⁰ Fischel, *supra* note 33, at 1454 (referring to Cary, *supra* note 481 (emphasis added)).

⁴⁹¹ Fischel, *supra* note 475, at 920.

retical and empirical evidence" contradicts Professor Cary's position and supports the proposition that "states such as Delaware have adopted enabling corporation statutes to allow private parties to enter into contractual arrangements that they find mutually advantageous."⁴⁹²

Also, Professor Fischel continues the argument in his 1991 book (with Judge Easterbrook), *The Economic Structure Of Corporate Law*.⁴⁹³ There the authors wrote: "As a matter of theory, the 'race for the bottom' cannot exist. Empirical studies confirmed the force of competition."⁴⁹⁴ Professor Roberta Romano, in her 1993 book *The Genius of American Corporate Law*⁴⁹⁵ strongly supports this position in a chapter entitled *The Federalism Debate*.⁴⁹⁶

A close analysis of the authorities relied on by Professor Fischel shows that he has overstated the case against Professor Cary's position. He and Judge Easterbrook do not give appropriate consideration to an empirical study by Professors Bradley and Schipani that directly supports Professor Cary's position. Also, a close review of Professor Romano's more refined analysis of this issue leads to the conclusion that there is substantial empirical support for Professor Cary's "race to the bottom" theory.

2. *The Empirical Support for the Criticism*

The sole piece of empirical evidence relied on by Professor Fischel in his *Race to the Bottom* article was a 1982 study by Professors Dodd and Leftwich⁴⁹⁷ in which they "investigate the case for federal chartering of corporations by examining evidence of the effect of the choice of a state of incorporation on the wealth of shareholders."⁴⁹⁸ In their 1991 book, Professor Fischel and Judge Easterbrook also cite to this study by Dodd and Leftwich, as well as to studies by Professor Romano and by

⁴⁹² *Id.* at 921.

⁴⁹³ FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

⁴⁹⁴ *Id.* at 214.

⁴⁹⁵ ROMANO, *supra* note 391, at 14-24.

⁴⁹⁶ *Id.* at 14-24.

⁴⁹⁷ Fischel, *supra* note 475, at 920-21.

⁴⁹⁸ Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. BUS. L. 259, 260 (1980).

Professors Baysinger and Butler, as support for the statement that "[e]mpirical studies confirmed the force of competition."⁴⁹⁹

Professors Dodd and Leftwich argue that if Professor Cary's position were correct, firms would earn negative abnormal returns when "managements initiate a change in the state of incorporation to a state that is supposedly more pro-management (such as Delaware)."⁵⁰⁰

Rather than finding abnormal negative returns, they find that reincorporations generally follow a period of abnormal positive returns and that after the reincorporation shareholders earn normal returns. They argue that these findings are inconsistent with Professor Cary's position, which they refer to as the "stockholder-exploitation hypothesis" and are consistent with the "cost-avoidance hypothesis."⁵⁰¹ They conclude that "contrary to the allegations of the supporters of federal regulation, stockholders are not made worse off when firms switch state of incorporation, even when they switch to that much-maligned state of Delaware."⁵⁰² They continue:

[T]he case for federal chartering is not supported by the evidence. The evidence is consistent with our hypothesis that managers of a firm take advantage of the competition among states to locate in a state which offers an efficient set of restrictions on the firm, given the firm's anticipated production-investment and financing decisions.⁵⁰³

The empirical findings in the Dodd and Leftwich study were refined in a 1985 empirical analysis of the "incorporation puzzle" by Professor Roberta Romano.⁵⁰⁴ Professor Romano

⁴⁹⁹ EASTERBROOK & FISCHEL, *supra* note 493, at 214.

⁵⁰⁰ Dodd & Leftwich, *supra* note 498, at 261.

⁵⁰¹ *Id.* at 275.

⁵⁰² *Id.* at 281.

⁵⁰³ *Id.* at 282.

⁵⁰⁴ Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) [hereinafter Romano, *Incorporation Puzzle*]. See also ROBERTA ROMANO, FOUNDATION OF CORPORATE LAW 87 (1993); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987) (discussing Delaware's impact on shareholder's benefits from corporate competition) [hereinafter Romano, *State Competition Debate*]; Roberta Romano, *State Competition for Close Corporation Charters: A Commentary*, 70 WASH. U. L.Q. 409 (1992) (commenting on relationship between courts and legislatures in

divides reincorporations into the following three categories: (1) reincorporations by target firms to take advantage of defensive tactics; (2) reincorporations by acquiring firms to better effectuate mergers and acquisitions; and (3) reincorporations for other purposes, such as the achievement of tax savings. She finds that on an aggregate basis, reincorporations produced positive abnormal returns of 4.1% and on a disaggregated basis each category produced the following positive abnormal returns: (1) merger and acquisitions—8.6%; (2) defensive tactics—1.3%; and (3) other reasons—0.6%.⁵⁰⁵ She finds that only the positive returns for mergers and acquisitions are statistically significant.⁵⁰⁶ She concludes that her findings are essentially consistent with those in the Dodd and Leftwich study: "This finding supports the view that a domicile change is not a negative present value event and is consonant with the cost-reducing implication of the transaction explanation of reincorporations."⁵⁰⁷

It is possible that Professor Romano's finding that reincorporations by acquiring firms produce positive abnormal returns is consistent with Professor Cary's theory.⁵⁰⁸ If the shareholders of potential acquirors benefit from reincorporations, it may be attributable to the expectation that the reincorporation will better position the acquiror to gain an advantage in dealing with the target's shareholders. Thus, a finding that the shareholders of reincorporating acquirors experience positive abnormal returns may be an indication that the shareholders of potential targets of the reincorporating acquirors experience offsetting negative abnormal returns reflecting the increased possibility that the acquirors may be in a better position to exploit the target's shareholders. If the abnormal returns for reincorporations for the purposes of mergers and acquisitions and of defensive tactics are ignored, the reincorporations for other purposes produce a statistically insignificant positive abnormal return of only 0.6%. If these reincorporations could be unbundled to focus only on those that are effectuated for the specific purpose of engaging in one of

production of corporate law).

⁵⁰⁵ Romano, *Incorporation Puzzle*, *supra* note 504, at 270.

⁵⁰⁶ *Id.* at 271.

⁵⁰⁷ *Id.* at 272-73.

⁵⁰⁸ Cary, *supra* note 481, at 700-01.

the transactions that Professor Cary has criticized, one might find negative abnormal returns. I do not find Professor Romano's study to be strongly supportive of either the Fischel/Easterbrook position or the Cary position.

In the article by Professors Baysinger and Butler, cited by Professor Fischel and Judge Easterbrook, the authors contend that since investors can choose to invest in corporations that are incorporated in states with strict fiduciary rules, "[a] uniform strict law would not benefit these shareholders. On the other hand, shareholders who prefer liberal laws would be denied a choice and thus injured."⁵⁰⁹ In any event, because of the election-out possibility, the change of control board concept is not a "uniform strict law."

3. *The Empirical Support for the Cary Position*

It would appear that Professor Fischel and Judge Easterbrook have overstated the empirical support for their race to the top theory. Also, they do not adequately address the 1989 empirical study by Professors Bradley and Schipani, which provides just the type of focused study of the market response to a specific legal rule that would be encompassed by Professor Cary's proposal for federal minimum fiduciary standards.⁵¹⁰ In their study, Professors Bradley and Schipani examine, through the mechanism of event studies, the market impact on the shares of Delaware firms as a result of the following two events.⁵¹¹ The first event was the Delaware Supreme Court's decision in *Van Gorkom*, in which directors were held personally liable for breach of the duty of care.⁵¹² The second event was the subsequent legislative response by enactment of section 102(b)(7) of the Delaware Business Corporation Law, which permits corporations to limit or eliminate monetary damages faced by directors for breach of the duty of care.⁵¹³

⁵⁰⁹ Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: the ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 462 (1985).

⁵¹⁰ Bradley & Schipani, *supra* note 372, at 69.

⁵¹¹ *Id.* at 57-59. Professors Bradley and Schipani also examine the market impact of these two events on insurance companies providing directors and officers insurance. This aspect is not examined here.

⁵¹² *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

⁵¹³ Delaware Business Corporation Law, DEL. CODE ANN. tit. 8, § 102(b)(7) (1991 & Supp. 2000).

Professors Bradley and Schipani explain that since *Van Gorkom* increases legal constraints placed on directors and section 102(b)(7) loosens these restraints, *Van Gorkom* and section 102(b)(7) "provide an opportunity to test empirically the relative importance of market constraints and legal constraints to shareholder wealth."⁵¹⁴ They set out the following alternative hypotheses regarding the *Van Gorkom* decision:

If the constraints imposed by the due care standard are important monitoring devices designed to keep management interests aligned with shareholder interests, we expect to see shareholder wealth increase in the wake of the [*Van Gorkom*] decision. Stronger liability rules are predicted to favor absentee stockholders. Alternatively, if market constraints are sufficient to prevent the interests of managers from diverging from those of shareholders, the tightening of legal constraints would unduly restrict management's ability to perform. Shareholder wealth would thus decrease.⁵¹⁵

And, Professors Bradley and Schipani set forth the following alternative hypotheses regarding the enactment of section 102(b)(7):

[T]o the extent section 102(b)(7) permits greater managerial discretion, the legal constraint theory predicts a decrease in shareholder wealth. The lack of monitoring would increase the incentives of directors to ignore shareholder interests and act in their self-interest. Conversely, the market constraint theory predicts that in lessening the constraints imposed on management decisionmaking, section 102(b)(7) should favorably affect shareholder wealth.⁵¹⁶

Professors Bradley and Schipani find "no significant change in the value of Delaware firms around the date of the [*Van Gorkom*] decision."⁵¹⁷ They go on to conclude:

[C]ontrary to either the market [Fischel] or the legal constraint [Cary] theories, [*Van Gorkom*] does not appear to have

⁵¹⁴ Bradley & Schipani, *supra* note 372, at 44.

⁵¹⁵ *Id.* at 44-45.

⁵¹⁶ *Id.* at 46.

⁵¹⁷ *Id.* at 58.

had a significant effect on the stock price of Delaware corporations vis-à-vis corporations incorporated in other states. . . . One possible reason is the persuasive value of Delaware case law on the corporate law of other states.⁵¹⁸

On the other hand, they find a "significant decrease in the relative values of Delaware firms in the wake of section 102(b)(7)"⁵¹⁹ They explain that this decrease in value "indicates that the relaxed liability exposure for violations of the duty of care standard allowed by this act is detrimental to the wealth of the stockholders of Delaware firms."⁵²⁰ The results are consistent with the legal constraint view that the enactment of section 102(b)(7) increased agency costs and reduced the value of the shares of these firms. They also found negative abnormal returns for firms adopting the limited liability provided by section 102(b)(7).⁵²¹

Finally, Professors Bradley and Schipani address the significance of their findings on the debate between Professor Cary's "race to the bottom" theory and Professor Fischel's "climb to the top" theory:

The negative economic effects incurred in the wake of Delaware's enactment of section 102(b)(7) are more consistent with William Cary's thesis that competition among states can be characterized as a race to the bottom. We end by noting that since July 1, 1986, the effective date of the Delaware statute, 37 states have enacted similar legislation.⁵²²

The findings of Professors Bradley and Schipani are not controverted and arguably are essentially confirmed by an empirical study by Professors Janjigian and Bolster of the performance of Delaware firms during the legislative period leading up to the enactment of section 102(b)(7).⁵²³ Although they conclude that "liability elimination does not have a significant

⁵¹⁸ *Id.* at 59.

⁵¹⁹ Bradley & Schipani, *supra* note 372, at 61.

⁵²⁰ *Id.*

⁵²¹ *Id.* at 63.

⁵²² *Id.* at 72.

⁵²³ Vahan Janjigian & Paul J. Bolster, *The Elimination of Director Liability and Stockholder Returns: An Empirical Investigation*, 13 J. FIN. RES. 53 (1990).

impact upon shareholder wealth,⁵²⁴ they also point out that "[r]esults indicate that Delaware firms performed worse than non-Delaware firms during the Delaware legislature's debate and approval of the liability-eliminating measure."⁵²⁵ Their overall conclusion, however, is that "[n]o systematic evidence is found indicating that . . . limitations on liability negatively affect shareholder wealth."⁵²⁶

The findings of Bradley and Schipani are essentially supported by an empirical study of the effects of the enactment of section 102(b)(7) by Professor Romano.⁵²⁷ She finds statistically significant abnormal negative returns on the day after the press reports of the enactment of section 102(b)(7) and on the day after the Senate passed the legislation.⁵²⁸ She says that her "findings are broadly consistent with Bradley and Schipani's finding of significantly negative cumulative abnormal returns upon the effective date of the statute . . ."⁵²⁹

Notwithstanding these findings she concludes: "Given the curious pattern of the CARs as well as the odd timing of the only significant CARs, the event study data provide no convincing support for a perceived deterrent effect from directors' liability for negligence."⁵³⁰ She criticizes the Bradley and Schipani study's findings of negative abnormal returns on the effective date of section 102(b)(7) because she argues that the effective date, which was two weeks after enactment, is essentially irrelevant for determining shareholder reaction.⁵³¹ She points out, however, that "there is also no other obvious event

⁵²⁴ *Id.* at 60.

⁵²⁵ *Id.* at 59. Also, in a study of the shareholder wealth effects of charter amendments by Delaware corporations to expand management protection by limiting directors' liability under section 102(b)(7) and increasing indemnification rights, Professors Netter and Poulsen find that "cumulative abnormal returns are negative for high insider ownership firms . . ." Jeffrey Netter & Annette Poulsen, *State Corporations and Shareholders: The Recent Experience*, FINANCIAL MANAGEMENT, Autumn 1989, at 29, 38.

⁵²⁶ Janjigian & Bolster, *supra* note 523, at 59.

⁵²⁷ Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990).

⁵²⁸ *Id.* at 1186.

⁵²⁹ *Id.* at 1187.

⁵³⁰ *Id.* at 1187-88.

⁵³¹ *Id.* at 1185.

that could have affected Delaware firms on the later dates and that thereby would explain the negative returns."⁵³²

In her 1993 book, *The Genius of American Corporate Law*, Professor Romano summarizes the results of the three studies of the effect of the enactment of section 102(b)(7) as follows:⁵³³

DELAWARE LIMITED LIABILITY STATUTE

Bradley and Schipani (1989)	Negative AR* on effective date
Janjigian and Bolster (1990)	Negative AR on newspaper announcement day and day of introduction to Senate
Romano (1990)	Negative AR on effective date, day after Senate action

*AR = Average Residual or Abnormal Return

She also reports that four studies of the effect of the adoption by firms of section 102(b)(7) charter provisions produce ambiguous results.⁵³⁴ She points out that "[e]vent studies of charter amendments may not, however, accurately identify an amendment's effect if investors anticipate that firms will adopt conforming charter amendments when the enabling statute is enacted."⁵³⁵ Although this analysis would seem to give credence to the consistent findings of negative abnormal returns around the date of enactment of section 102(b)(7) (which forcefully support Professor Cary's thesis), Professor Romano nevertheless concludes, "[t]he most cogent interpretation of these data is that the limited liability statute did not adversely affect shareholders, a conclusion more consistent with Winter's than Cary's characterization of state competition."⁵³⁶

I read the empirical evidence regarding section 102(b)(7) as strongly supportive of the Cary thesis, and Professor Romano reads the evidence as unsupportive. However, with regard to the empirical evidence concerning the economic impact of state

⁵³² Romano, *supra* note 527, at 1187.

⁵³³ ROMANO, *supra* note 391, at 20.

⁵³⁴ *Id.*

⁵³⁵ *Id.* at 22.

⁵³⁶ *Id.* at 24.

takeover legislation, such as control share statutes, she concludes that "[e]mpirical research on the effects of [state] takeover laws on shareholder wealth is most consistent with Cary's view of the harmful effect of state competition."⁵³⁷

Given that the general thrust of both section 102(b)(7) and state takeover statutes is to protect incumbent directors and that the enactment of these provisions was accompanied by significant abnormal shareholder returns, the empirical evidence seems overwhelmingly supportive of Professor Cary's thesis. This is so even though, as Professor Romano points out, the "[e]vent studies of Delaware's second-generation statute find no significant price effect . . . [,] [which] is consistent with viewing Delaware's efforts at regulating takeovers as less restrictive than those of other states."⁵³⁸ Indeed, this is an illustration that, in the context of state takeover legislation, states such as Pennsylvania that have enacted highly restrictive provisions have harmed shareholders,⁵³⁹ whereas Delaware, with its less restrictive takeover provision, section 203, and its *Unocal* enhanced scrutiny of defensive tactics, has been more protective of shareholder rights.⁵⁴⁰ This observation is, of course, consistent with Cary's general thesis that the protection of shareholder rights is beneficial.

A study by Professor Robert Daines provides additional empirical support for the proposition that in the takeover area Delaware law is more efficient than the law of many other states.⁵⁴¹ Using a Tobin Q analysis, Professor Daines finds that "Delaware firms are worth more than similar non-Delaware firms."⁵⁴² Professor Daines explains that Tobin's Q provides an estimate of a company's market value divided by the company's replacement cost and that the "ratio represents a firm's investment or growth opportunities, including those

⁵³⁷ *Id.* at 60.

⁵³⁸ ROMANO, *supra* note 391, at 67.

⁵³⁹ See 15 PA. CONST. STAT. ANN. § 2544 (1995).

⁵⁴⁰ See Delaware Business Corporation Law, DEL. CODE ANN. tit. 8, § 203 (1991 & Supp. 2000); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

⁵⁴¹ Robert Daines, *Does Delaware Law Improve Firm Value?*, Nov. 1999, available in Social Science Research Network Electronic Library, <<http://www.ssrn.com>>.

⁵⁴² *Id.* at 4.

added by management and corporate law rules.”⁵⁴³ In addressing why Delaware law “may add value,” Professor Daines says that the

best view of the evidence is that Delaware corporate law improves firm value by facilitating the sale (acquisition) of the firm. First, Delaware law is less likely than other states to entrench incumbent managers due to its takeover law, political economy and specialized corporate courts Delaware firms receive significantly more takeover bids and are significantly more likely to receive at least one bid and to be acquired. Firms in states that raise significant barriers to hostile bids are worth less and receive significantly fewer bids.⁵⁴⁴

Professor Daines goes on to conclude that Delaware “produces legal rules and courts that appear to improve firm value.”⁵⁴⁵

I would like to make three observations about Professor Daines’ findings: First, the findings do not show that Delaware law is optimal and cannot be improved upon; the findings merely show that Delaware law is more economically efficient than the laws of other states. Second, the Cary thesis would clearly support Delaware law over the restrictive anti-takeover provisions adopted by many states, and the growth of restrictive state takeover statutes is just another variant of the race to the bottom. Third, the adoption of the change of control provisions proposed here would certainly be an improvement over both the restrictive state takeover laws and the less restrictive Delaware law.

Finally, Professor Fischel and Judge Easterbrook pose the question: “Does the ‘race for the top’ survive the adoption of antitakeover statutes?”⁵⁴⁶ They respond that the “answer depends on how the thesis is characterized.”⁵⁴⁷ They say, on the one hand, that “[i]f the claim is that the competition among states for incorporations always produces the optimal result, it

⁵⁴³ *Id.* at 10.

⁵⁴⁴ *Id.* at 5.

⁵⁴⁵ *Id.* at 6.

⁵⁴⁶ EASTERBROOK & FISCHEL, *supra* note 493, at 222.

⁵⁴⁷ *Id.*

stands refuted."⁵⁴⁸ On the other hand, they argue that "if the thesis is that competition creates a powerful tendency for states to enact laws that operate to the benefit of investors (the opposite of the Cary view), it is alive and well."⁵⁴⁹ They do not explain why, in the face of this "powerful tendency," states would rush to enact anti-takeover laws that in their view are antithetical to shareholder interests.

In any event, it is not necessary to delve further into this dilemma; it is sufficient to note that the proposal here would preempt state takeover statutes because the change of control boards would have sufficient authority to accomplish the purposes of those statutes in appropriate circumstances.

4. Summary

In summary, the theoretical case made by Professor Fischel and others against Professor Cary's position is at bottom based on the false assumption that public shareholders are on an equal bargaining footing with managers and that the resulting bargain between shareholders and managers is in the best interest of both parties. Their theory ignores the real life potential for managerial exploitation of the "rational ignorance" of public shareholders. Thus, their theory closes its eyes to the unlevel playing field between public shareholders and managers.

Although Professor Fischel may have been correct when he said in 1982 that "not one shred of empirical evidence has been adduced to support [Professor Cary's] view,"⁵⁵⁰ he could not make that statement today. The study of reincorporations by Dodd and Leftwich may on its face support Professor Fischel's theoretical position,⁵⁵¹ but the more focused reincorporation study by Professor Romano called into question the unqualified conclusions reached by Dodd and Leftwich.⁵⁵² Further, the even more focused study of the effects of the enactment of section 102(b)(7) by Bradley and Schipani, (and arguably by Janjigian and Bolster, and Romano) provide vigorous empirical

⁵⁴⁸ *Id.*

⁵⁴⁹ *Id.*

⁵⁵⁰ Fischel, *supra* note 475, at 914.

⁵⁵¹ Dodd & Leftwich, *supra* note 498, at 260.

⁵⁵² Romano, *State Competition Debate*, *supra* note 504, at 732.

support for Professor Cary's position.⁵⁵³ Thus, the state of the empirical evidence has come full circle.

Also, the race to the top theory is under assault at the theoretical level. In his 1992 article Professor Bebchuk asserts that the capital market, the product market, the market for managers and the market for corporate control, which Professor Fischel assumes will police managers, are not effective in dealing with significant redistributive issues.⁵⁵⁴ These are issues in which the size of the potential transfer from shareholders to managers (the distributive element) is significant relative to the potential effect on overall value (the efficiency element).⁵⁵⁵ Thus, these situations arise where a particular action by a manager may give rise to a large personal windfall but have a small effect on overall firm value.⁵⁵⁶ Professor Bebchuk explains:

The markets for corporate control, managerial labor, additional capital, and company products discipline managers' decisions to some extent. The operation of these markets may well ensure that managers will seek (and states in turn will provide) only value increasing rules with respect to issues that are not significant redistributive. However, . . . the various market forces invoked by race for the top adherents do not ensure that managers will not seek value-decreasing rules with respect to other types of issues. In particular, market discipline notwithstanding, managers may seek such rules with respect to issues that are significantly redistributive.⁵⁵⁷

The "omnipresence" of conflicts of interests in mergers and acquisitions is in large measure attributable to the significant redistributive issues embedded in such transactions. The proposal here for a change of control board would (unless the independent shareholders elect-out) put the control of all significant redistribution issues arising in the context of a change of con-

⁵⁵³ Bradley & Schipani, *supra* note 372, at 70.

⁵⁵⁴ Bebchuk, *supra* note 487, at 1461.

⁵⁵⁵ *Id.*

⁵⁵⁶ For a discussion of a manager's role in the development of corporate law rules, see Carney, *Competition for Corporate Charters*, *supra* note 472, at 303-06.

⁵⁵⁷ Bebchuk, *supra* note 487, at 1467.

trol of publicly-held corporations in the hands of a truly independent arbiter.

Finally, in a 1999 article entitled *Federalism and Takeover Law: the Race to Protect Managers from Takeovers*,⁵⁵⁸ Professors Bebchuk and Ferrell make a powerful argument that the "supporters of state competition—Ralph Winter, Frank Easterbrook, Daniel Fischel and Roberta Romano"⁵⁵⁹ should reconsider their position. The authors say that "[w]hile the pro-state competition view has a serious problem accounting for existing state takeover law . . . the view that Cary held, and that we are advocating, has no problem whatsoever explaining this."⁵⁶⁰ They draw the following conclusions on the race to the bottom theory:

On some important issues, states might have incentives to provide rules that are attractive to managers but not shareholders. Takeover law is one important area in which state competition is likely to fail. There are strong theoretical reasons to expect that state competition will work to produce a body of corporate law that excessively protects incumbent managers. The development of state takeover law . . . is consistent with this view. It should lead the many [including Easterbrook, Fischel, and Romano] who offer unqualified support of state competition to reassess their position.⁵⁶¹

VII. SURVEY OF OTHER PROPOSALS FOR ADDRESSING CHANGE OF CONTROL TRANSACTIONS AND COMPARISON WITH CHANGE OF CONTROL BOARD

A. Survey

This section surveys many of the other proposals for addressing various types of change of control transactions. This section does not, however, provide an exhaustive review of the proposals in this area.

On the free market side, Professor Fischel and Judge Easterbrook have argued that a target's board should not be

⁵⁵⁸ Bebchuk & Ferrell, *supra* note 3.

⁵⁵⁹ *Id.* at 1194.

⁵⁶⁰ *Id.* at 1198.

⁵⁶¹ *Id.* at 1199.

able to engage in any defensive action.⁵⁶² This view is known as the managerial passivity approach and is based on the assumption that this system will maximize aggregate shareholder value because there will be a larger number of tender offers than would otherwise occur if managers undertake defensive actions.⁵⁶³

On the other hand, Martin Lipton has argued strenuously for a standard that permits a target's directors to use defensive tactics and that provides them protection under the business judgment rule.⁵⁶⁴ This standard is similar to (but less demanding than) the standard that applies under current Delaware law and under the ALI's proposed rules, both of which provide an enhanced business judgment rule standard of review for defensive actions.⁵⁶⁵ Also, under certain state corporate laws, such as the Pennsylvania corporate law at issue in *Norfolk Southern Corp. v. Conrail, Inc.*,⁵⁶⁶ a target's directors have very broad latitude to oppose a hostile takeover, even broader in some cases than the business judgment rule.⁵⁶⁷

As an intermediate position, Professor Bebchuk has argued that in the face of a hostile takeover, a target's board should have to auction the target.⁵⁶⁸ In a paper that is soon to be published in the *Virginia Law Review*, Professors Bebchuk and Ferrell propose the adoption of an elective federal takeover law that would not be as protective of management as current state law.⁵⁶⁹ Their proposal is broadly consistent with the proposal set out here.

⁵⁶² EASTERBROOK & FISCHER, *supra* note 493, at 171-74.

⁵⁶³ Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

⁵⁶⁴ See, e.g., Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 THE BUS. LAW. 101, 109-10 (1979); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 28-35 (1987) [hereinafter Lipton, *Finance Corporatism*].

⁵⁶⁵ See Thompson, *supra* note 2, at 236.

⁵⁶⁶ No. 96-7167, 1997 U.S. Dist. LEXIS 978 (E.D. Pa. Jan. 9, 1997).

⁵⁶⁷ *Norfolk So. Corp.*, 1997 U.S. Dist. LEXIS 978, at *5-7.

⁵⁶⁸ Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982). See also, Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 821 (1981) (proposing limited roles for management as means of reducing effects of defensive tactics).

⁵⁶⁹ Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001).

Martin Lipton has also made two legislative proposals for dealing with hostile takeovers and corporate governance in general. In a 1987 article, Lipton laid out a comprehensive legislative plan for addressing hostile takeovers,⁵⁷⁰ and he said that if this plan is adopted, defensive tactics could be prohibited.⁵⁷¹ The first part of his legislative proposal would amend the Williams Act to eliminate partial bids by requiring an acquiror in a tender offer to bid for all of a target's stock.⁵⁷² No more than 5% of a target's stock could be purchased without making a tender offer for all of the stock.⁵⁷³ Further, the threshold for open market purchases that must be reported under section 13(d) of the Securities Exchange Act of 1934 would be reduced from 5% to 2%.⁵⁷⁴ The period during which a tender offer would have to remain open would be extended from the current 20 business days to 120 calendar days to "give the board a realistic opportunity to determine whether the target is best served by remaining independent. . . ."⁵⁷⁵ To eliminate what he describes as "an element of coercion in every tender offer," the target's shareholders would have the right to vote on the tender offer within the 120 day period.⁵⁷⁶ If the bidder did not receive a majority vote, it would have to withdraw its bid.⁵⁷⁷

In addition, Lipton proposes that junk-bond financed bust-up takeovers be discouraged by denying the deductibility for the interest on junk bonds issued to finance hostile takeovers or to repurchase a company's own equity.⁵⁷⁸ To discourage institutions from holding investments for the short-term, he proposes a graduated tax on investment gains that would go from 60% on positions held for not more than one year declining to 35% on positions held for more than five years.⁵⁷⁹

Lipton states that if these proposals were adopted, "the takeover defenses currently used to combat such abuses will no

⁵⁷⁰ Lipton, *Finance Corporatism*, *supra* note 564.

⁵⁷¹ *Id.* at 64-65.

⁵⁷² *Id.* at 61.

⁵⁷³ *Id.*

⁵⁷⁴ *Id.*

⁵⁷⁵ Lipton, *Finance Corporatism*, *supra* note 564, at 62.

⁵⁷⁶ *Id.*

⁵⁷⁷ *Id.* at 63.

⁵⁷⁸ *Id.*

⁵⁷⁹ *Id.* at 64.

longer be justified.”⁵⁸⁰ Specifically, he proposes an exchange rule requiring one share, one vote; annual election of directors; and a prohibition against staggered boards and shark repellent charter provisions.⁵⁸¹ Lipton concludes, “[w]ith limitations on abusive takeovers in place, there no longer will be a justification for structural defenses that treat common stockholders unequally or are triggered by a change of control, such as poison pills, lock-up options, and fair-price provisions.”⁵⁸²

Professor Lowenstein has made a similar legislative proposal.⁵⁸³ He has proposed that hostile tender offers be required to remain open for at least six months and that any defensive tactics employed by the target’s directors be required to be approved by the shareholders.⁵⁸⁴

Although Martin Lipton proposes annual election of directors in the 1987 article,⁵⁸⁵ to facilitate long term operating success, in a 1991 article he proposes, *inter alia*, that directors serve for a five-year period.⁵⁸⁶ Specifically this proposal would:

[R]eplace annual elections of directors with quinquennial elections; bar nonconsensual changes in control between elections; provide major stockholders with direct access to the corporate proxy machinery in connection with the quinquennial election; provide for a detailed five-year report, which would be independently evaluated by an outside advisor . . . ; and tie significant management compensation awards, as well as significant penalties, to the corporation’s performance against the five-year plan.⁵⁸⁷

He goes on to point out that under this proposal the “quinquennial election would be the sole means of accomplish-

⁵⁸⁰ Lipton, *Finance Corporatism*, *supra* note 564, at 64.

⁵⁸¹ *Id.* at 65.

⁵⁸² *Id.*

⁵⁸³ Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983).

⁵⁸⁴ *Id.* at 255.

⁵⁸⁵ Lipton, *Finance Corporatism*, *supra* note 564, at 65.

⁵⁸⁶ Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

⁵⁸⁷ *Id.* at 190.

ing nonconsensual changes of control.”⁵⁸⁸ There would be a prohibition against an acquisition of more than 10% of a corporation’s stock without the directors’ approval.⁵⁸⁹ Between meetings, a corporation’s directors could enter into a consensual acquisition.⁵⁹⁰ Since hostile transactions would be prohibited except in connection with the quinquennial meetings, takeover defenses, including the poison pill, would be eliminated and takeover-related state legislation would be prohibited.⁵⁹¹

In a 1996 article, Professor McGinty proposed that a public corporation’s shareholders be given the authority to initiate voluntary dissolution proceedings.⁵⁹² If a majority of the shareholders approved the dissolution, the board of the corporation would be required to obtain the highest value by auctioning the corporation.⁵⁹³ He sees this voluntary dissolution procedure as the antidote to sophisticated takeover defenses that put shareholders at the “mercy of managers, who can remove the market’s most serious constraints on managerial inefficiency [*i.e.*, the hostile takeover] and, in effect, entrench themselves.”⁵⁹⁴ Professor McGinty points out that his proposal is compatible with a proposal made by Bratton and McCahery which would give shareholders the authority to “initiate charter amendments dealing with corporate process and structure.”⁵⁹⁵

Professor McGinty would have a quinquennial opt-out election pursuant to which the shareholders would choose to waive or retain the right to initiate a voluntary dissolution.⁵⁹⁶ The default rule would be the opt-out.⁵⁹⁷ He says that this opt-out is consistent with both a proposal by Professor Coffee that would require supermajority charter provisions to be reviewed every three years by a similar, supermajority shareholder vote,⁵⁹⁸ and a proposal by Professor Romano that would per-

⁵⁸⁸ *Id.* at 240.

⁵⁸⁹ *Id.* at 241.

⁵⁹⁰ *Id.* at 244.

⁵⁹¹ Lipton & Rosenblum, *supra* note 586, at 241.

⁵⁹² Park McGinty, *Replacing Hostile Takeovers*, 144 U. PA. L. REV. 983 (1996).

⁵⁹³ *Id.* at 987.

⁵⁹⁴ *Id.* at 986-87.

⁵⁹⁵ *Id.* at 997. See William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1903-25 (1995) (discussing production of strategies for self-regulation through shareholder participation).

⁵⁹⁶ McGinty, *supra* note 592, at 1071.

⁵⁹⁷ *Id.*

⁵⁹⁸ *Id.* at 1072 n.229. See John C. Coffee, Jr., *Regulating the Market for Corpo-*

mit shareholders to opt-out of the Williams Act if they do not want their corporation to hold auctions, thereby increasing the possibility of takeover, but possibly at a lower premium.⁵⁹⁹

Professor McGinty distances his proposal from Martin Lipton's quinquennial election proposal, which the professor describes as "unappealing because it follows essentially a socialist, or at least command economy, model for running free market firms" and it reduces "directors' discretion to respond to changing conditions [thereby] discard[ing] the dynamic responsiveness of capitalist forms of organization."⁶⁰⁰

Professor Weiss has proposed that the Williams Act be amended to incorporate certain provisions of Delaware's business combination statute.⁶⁰¹ This statute prohibits second-step freezeout mergers for a three-year period after a hostile acquiror acquires more than 15% of a target's stock, unless: (1) the acquiror acquires 85% of the target's stock, (2) before the acquisition the target's board approves the acquisition, or (3) after the acquisition the target's board and two-thirds of the disinterested shareholders approve the transaction.⁶⁰² His proposal would preempt both state antitakeover statutes and most takeover defenses.⁶⁰³

Finally, in a 1998 article, Professor Romano proposes a "regulatory approach of competitive federalism, under which firms select their securities regulator from among the fifty states and the District of Columbia, the SEC, or other nations."⁶⁰⁴ Thus, she would permit a corporation to elect-out of the Securities Act of 1933 and the Securities Exchange Act of 1934, including the Williams Act. Without commenting on the general merits of this proposal, the change of control board concept is broadly consistent with the general thrust of her

rate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 COLUM. L. REV. 1145, 1262-63 (1984) (discussing durational limits of supermajority provisions).

⁵⁹⁹ McGinty, *supra* note 592, at 1072 n.229. See Romano, *supra* note 183, at 165-66 (proposing amendments to Williams Act).

⁶⁰⁰ McGinty, *supra* note 592, at 1072 n.229.

⁶⁰¹ Elliott J. Weiss, *A Proposal for a Federal Takeover Law*, 9 CARDOZO L. REV. 1699 (1988).

⁶⁰² Delaware Business Corporation Law, DEL. CODE ANN. tit. 8, § 203 (1991 & Supp. 2000).

⁶⁰³ See Weiss, *supra* note 601, at 1700.

⁶⁰⁴ Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2427 (1998).

proposal because a company could elect-out of the change of control provision and thereby be governed by the law of the jurisdiction of incorporation.

B. Comparison of Other Proposals With the Change of Control Board Concept

The proposal here for a change of control board would address many of the concerns that motivate these various proposals. Indeed, the change of control board concept has the flexibility in a particular context to accommodate the polar opposite positions of the managerial passivity approach of Easterbrook and Fischel or the managerial action approach of Lipton. In certain circumstances, the change of control board may decide to take no defensive action and let the shareholders decide, as proposed by Easterbrook and Fischel. In other circumstances, it may erect a "just say no" defense, which is consistent with Lipton's approach. Of course, if the circumstances require, the change of control board could adopt the intermediate auction approach of Bebchuk. The point is that the optimum approach (managerial passivity, managerial action, auction, or other) will depend on the circumstances, and the change of control board has the authority and the expertise to fashion an appropriate response.

The change of control board is more flexible than Lipton's legislative proposal of a 120 day tender offer period with the target's shareholders having the right to vote on the tender offer. Lipton's proposal would unnecessarily delay transactions that for good business reasons need to close quickly. Also, if the change of control board wanted to have a shareholder vote it could provide for one. For the same reasons, the change of control board concept is more flexible than Professor Lowenstein's proposal for a six month tender offer period and for shareholder approval of defensive tactics. If in a particular case a change of control board wanted to seek shareholder approval of any defensive tactics it undertook, it could do so.

The change of control concept is obviously more flexible than the quinquennial election proposal made by Lipton. It would be unwise to insulate a corporation from the potential of a hostile acquisition for any period, let alone for five years, as his proposal would do. Also, Lipton's proposal would unfairly

strengthen the hand of a corporation's board because it could, within the five-year period, enter into consensual transactions.

Because the change of control board concept would not act as a deterrent to takeovers, there would be no reason to give the shareholders the right to initiate dissolution procedures, as Professor McGinty has proposed. Also, since shark repellent charter provisions would be prohibited, it would not be necessary to get a shareholder vote on such provisions as Professor Coffee has proposed. Professor Weiss's proposal for a federal statute similar to Delaware's business combination statute would not be needed with the change of control board concept. Finally, the adoption of Professor Romano's proposal for an elective securities law regime should not have an adverse effect on the adoption of the change of control board concept.

In summary, the change of control board concept provides for great flexibility in responding to the dynamic market for corporate control. It does not provide a set of rigid rules, which, depending on the circumstances, may or may not maximize shareholder welfare. Finally, all of the surveyed proposals are directed at hostile acquisitions, but the change of control board concept applies to all forms of change of control transactions involving public corporations: arm's-length mergers and acquisitions, management buyouts, tender offers, and freezeouts.

VIII. COMPARISON OF CHANGE OF CONTROL BOARD CONCEPT WITH RULES GOVERNING A TARGET'S DIRECTORS, IN THE UNITED KINGDOM, GERMANY, AND THE EUROPEAN UNION

The approach to takeover regulation in the United Kingdom and Germany and the proposed takeover regulation of the European Union are significantly different from the U.S. approach.⁶⁰⁵ This is obviously a complex topic, and the discussion here focuses on only the rules governing the defensive actions of the target's board.

In the United Kingdom, takeovers of publicly-held corporations are governed by the City Code on Takeovers and Mergers

⁶⁰⁵ See Edward F. Greene et al., *Toward a Cohesive International Approach to Cross-Border Takeover Regulation*, 51 U. MIAMI L. REV. 823, 824 (1997) (noting that United States regulates takeovers by statute while United Kingdom and Germany regulate through non-statutory bodies); see generally THOMPSON, *supra* note 324, ch. 26, pt. IV.

(*City Code*),⁶⁰⁶ which is administered by the Panel on Takeovers and Mergers. The Panel consists of market participants and relies on non-legal sanctions for enforcement. The *City Code* consists of general principles and specific rules, including rules governing Substantial Acquisitions of Shares (SARs).

General Principles 7 of the *City Code* prohibits the target's board from taking defensive actions after the commencement of a takeover bid without the prior approval of the target's shareholders:

At no time after a bona fide offer has been communicated to the board of the offeree company [the target], or after the board of the offeree company has reason to believe that a bona fide offer might be imminent, may action be taken by the board of the offeree company in relation to the affairs of the company, without the approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits.⁶⁰⁷

General Principle 9 provides in part that when giving advice to the shareholders the directors should consider the "shareholders' interest taken as a whole, together with those of employees and creditors."⁶⁰⁸

Rule 3.1 of the *City Code* provides that the "board of the offeree company must obtain competent independent advice on any offer and the substance of such advice must be made known to its shareholders."⁶⁰⁹

Germany follows a similar approach in *The German Takeover Code*.⁶¹⁰ Article 19, under the General Principles of this code, provides: "Following publication of a public tender offer, and until the outcome of the tender offer is published, the exec-

⁶⁰⁶ PANEL ON TAKEOVERS AND MERGERS, CITY CODE ON TAKEOVERS AND MERGERS AND THE RULES GOVERNING SUBSTANTIAL ACQUISITIONS OF SHARES (9th ed. 1996) [hereinafter CITY CODE]; see generally, THOMPSON, *supra* note 324, § 26.9.B.

⁶⁰⁷ CITY CODE, *supra* note 606, at General Principle 7.

⁶⁰⁸ *Id.* at General Principle 9.

⁶⁰⁹ *Id.* at Rule 3.1.

⁶¹⁰ THE GERMAN TAKEOVER CODE (ÜBERNAHMEKODEX) OF THE EXCHANGE EXPERT COMMISSION AT THE FEDERAL MINISTRY OF FINANCE (July 14, 1995, amended January 1, 1998) [hereinafter GERMAN TAKEOVER CODE]. See generally, THOMPSON, *supra* note 324, at § 26.10.B.

utive or managing body of the target company . . . may not take any measures that run counter to the interest of the holders of securities in taking advantage of the tender offer.”⁶¹¹

The Article prohibits the following:

- (1) the issuance of new securities;
- (2) a substantial change to the assets or liabilities of the target company; and
- (3) the conclusion of agreements outside of the scope of ordinary business activities.⁶¹²

The European Commission currently has a Takeover Proposal (EC Takeover Proposal),⁶¹³ which, if adopted, would establish takeover standards that all members of the European Union would have to adopt.⁶¹⁴ Article 8 of the EC Takeover Proposal provides that member states shall ensure that rules are in force requiring that after receiving the information concerning the bid, and until the result of the bid is made public or lapses:

the board of the offeree company should abstain from completing any action other than seeking alternative bids which may result in the frustration of the offer, and notably from the issuing of shares which may result in a lasting impediment to the offeror to obtain control over the offeree company, unless it has the prior authorisation of the general meeting of the shareholders given for this purpose during the acceptance of the bid ⁶¹⁵

The December 9, 2000 issue of the Economist reports that the European Parliament’s legal affairs committee has voted to amend the current EC Takeover Proposal to “allow national supervisors to give company boards the right to devise defensive measures [such as poison pills] to deter predators, without

⁶¹¹ GERMAN TAKEOVER CODE, *supra* note 610, at art. 19.

⁶¹² *Id.*

⁶¹³ PROPOSAL FOR A 13TH EUROPEAN PARLIAMENT AND COUNCIL DIRECTIVE ON COMPANY LAW CONCERNING TAKEOVER BIDS, (December 1999) [hereinafter EC TAKEOVER PROPOSAL]. See generally, THOMPSON, *supra* note 324, § 26.8.C.

⁶¹⁴ See generally Greene, *Cross-Border Takeover*, *supra* note 605, at 862; THOMPSON, *supra* note 324, § 26.8.C.

⁶¹⁵ EC TAKEOVER PROPOSAL, *supra* note 613, art. 8.

first obtaining shareholder approval."⁶¹⁶ It is not certain whether this amendment will be finally adopted.

The approach to defense tactics taken by the United Kingdom and Germany and posited in the current draft of the EC Takeover Proposal is similar to the management passivity approach urged by Judge Easterbrook and Professor Fischel.⁶¹⁷ This approach should not be followed for at least two reasons. First, Professors Bradley and Schipani identified a collective action problem whereby, a passive board could permit an acquiror to take unfair advantage of the target's shareholders.⁶¹⁸ Second, there may be times when the market does not reflect the value of the target's assets, and in such cases it may be appropriate for a board to "just say no." For these reasons, the change of control board is superior to the approaches taken by the United Kingdom, Germany, the EC, and Easterbrook and Fischel. The change of control board concept does, however, contemplate the appointment of independent advisors to the board, which is a requirement of Rule 3.1 of the *City Code*.⁶¹⁹

There is one final point on the merger proposals of the European Union. In its 1978 Directive *Concerning Mergers of Public Limited Liability Companies*, the European Commission promulgated a rule which in the acquisition of a public corporation requires: "[o]ne or more experts, acting on behalf of each of the merging companies but independent of them, appointed or approved by a judicial or administrative authority, [to] examine the draft terms of merger and draw up a written report to shareholders."⁶²⁰ The proposal here extends this EC requirement of expert independence to the target's board.

⁶¹⁶ *Poisoned?*, The Economist, Dec. 9th-15th, 2000, at 82, 82.

⁶¹⁷ See Easterbrook & Fischel, *supra* note 493, at 171-74.

⁶¹⁸ Bradley & Schipani, *supra* note 372.

⁶¹⁹ CITY CODE, *supra* note 606.

⁶²⁰ *European Commission*, Third Council Directive of 9 October 1978, Based on Article 54(3)(G) of the Treaty, Concerning Mergers of Public Limited Liability Companies, 78/855/EEC, art. 10.1; see generally THOMPSON, *supra* note 324, § 26.8.A.

IX. ANALYSIS OF NEGATIVE COMMENTS OF SEVERAL MERGER AND ACQUISITION PRACTITIONERS

Several leading merger and acquisition practitioners strongly criticized the change of control board concept. Here, I summarize the general thrust of these critiques and provide a response.

The critique of Martin Lipton, one of the country's preeminent merger and acquisition practitioners, is short and to the point. After saying he does not agree with the change of control board concept, he writes: "In practice, I think this would be the same as the rule of passivity Easterbrook and Fischel argued for in the 80's and which I argued against in our extensive exchange of articles. The rule of passivity received no support and quickly disappeared."⁶²¹

It is highly unlikely that a change of control board would stand passive in the face of an acquisition proposal. To the contrary, the change of control board would likely be very active in critically evaluating the plans and prospects of the target under the current board and under the proposals of the acquiror.

Also, the reach of the change of control board concept is much broader than the reach of Easterbrook and Fischel's passivity principle. The passivity rule would apply only in the context of a hostile tender offer,⁶²² whereas the change of control board concept would apply to any proposal, whether friendly or hostile, to acquire a publicly-held target.

Mr. Lipton goes on to say that he thinks "Delaware has evolved the best approach" and that he supports it.⁶²³ He further says that he is "strongly opposed to any federal role in corporate governance."⁶²⁴ This opposition to a federal role in corporate governance was also echoed by Marshall L. Small, one of the reporters for the Corporate Governance Project. Mr. Small writes:

⁶²¹ Letter from Martin Lipton, Senior Partner, Wachtell, Lipton, Rosen and Katz, to Samuel C. Thompson, Jr., Professor and Director, Center for the Study of Mergers and Acquisitions, University of Miami School of Law.

⁶²² EASTERBROOK & FISCHEL, *supra* note 493, at 171-74.

⁶²³ Letter from Martin Lipton to Samuel C. Thompson, Jr., *supra* note 550.

⁶²⁴ *Id.*

I should start my response by disclosing that I am very cautious about trying to solve perceived problems through governmental intervention. My basic philosophy in the area of corporate governance is to encourage governance procedures in the private sector that will create a credible climate of corporate accountability to shareholders and the other constituencies served by the business community. Accordingly, when you broached the idea of a government appointed control board, I was initially skeptical but willing to consider objectively your proposal. Having now read your draft article and your proposed Section 14A of the Exchange Act, my views have not changed, and I must advise you that I think the proposal is a bad idea.⁶²⁵

Dennis S. Hersch, the head of the mergers and acquisitions department at Davis Polk & Wardwell, makes a similar point regarding governmental intervention: "I submit that the kinds of decisions that directors must make in change of control transactions cannot—and should not—be delegated to some appointed bureaucrat"⁶²⁶

In response to these governmental intervention points, there is currently substantial governmental intervention in the merger and acquisition market through the widespread adoption of state takeover laws, which would be preempted by Proposed Section 14A(m)(2) of the Securities Exchange Act of 1934. Also, the substantial litigation in the merger and acquisition market is a form of governmental intervention. For example, Herbert Wachtell, a leading takeover litigator, says,

[t]akeover litigation is unique [and] . . . [y]ou have to commence litigation immediately. You have to get out your deposition notices. You have to make your motions for expedited discovery You have to be scheduling your applications for temporary restraining orders, stays, preliminary injunctions and the like.⁶²⁷

⁶²⁵ Letter from Marshall L. Small, Senior of Counsel, Morrison & Foerster, to Samuel C. Thompson, Jr., Professor and Director, Center for the Study of Mergers and Acquisitions, University of Miami School of Law (Feb. 25, 1998).

⁶²⁶ Letter from Dennis S. Hersch, Panter, Davis, Polk & Wardwell, to Samuel C. Thompson, Jr., Professor and Director, Center for the Study of Mergers and Acquisitions, University of Miami School of Law (Feb. 10, 1998).

⁶²⁷ Herbert M. Wachtell, *Special Tender Offer Litigation Tactics*, 32 BUS. LAW.

Adoption of the change of control board concept should dramatically reduce the amount of takeover related litigation, thereby reducing judicial interference in the market for corporate control.

Further, under the change of control concept, decisions would not be made by an "appointed bureaucrat" but rather by experienced and independent members of the change of control board who are appointed on an objective basis by a Change of Control Official, who has functions quite similar to those of a U.S. Trustee in bankruptcy matters.

With regard to arm's-length merger and acquisition transactions, Mr. Small says: "I believe that at least in arm's-length non-hostile merger transactions, current corporate governance mechanisms can successfully resolve any such conflicts."⁶²⁸

Certainly, a target's board may act appropriately in an arm's-length, non-hostile merger, but there is also great potential in such transactions for the controlling members of the target's board to feather their own nests. For example, the target's board may negotiate significant golden parachutes or employment payments, at the expense of the target's shareholders. We will never know how many friendly acquisitions have been completed at a price less than the maximum the target's shareholders could have received.

With regard to management buyouts and freezeouts, Mr. Small argues:

[E]ven where conflicts are sharper—as in management buyout or cashout of minority shareholders' transactions—private sector mechanisms available, through use of independent board committees, seem to me to be as effective as any government-appointed board—which must grapple with the same issues as incumbent directors.⁶²⁹

Here, Mr. Small is at odds with former Chancellor Allen of the Delaware Chancery Court who has said that "the jury is still out on the question whether the special committee device

1433, 1433 (1977).

⁶²⁸ Letter from Marshall L. Small to Samuel C. Thompson, Jr., *supra* note 625.

⁶²⁹ *Id.*

works well enough, often enough, for the law to continue to accord it weight⁶³⁰ The change of control board is especially needed in these transactions.

Mr. Small also says, "I believe the use of the control board mechanism, as proposed, will . . . have a chilling effect on merger activity and instead of enhancing shareholder value and providing economic efficiency in the merger market, such a mechanism will in my opinion have exactly the opposite effect."⁶³¹ I believe Mr. Small is wrong on this point. By taking all types of defensive tactics out of the hands of a target's directors, the change of control board concept should facilitate acquisitions and thereby increase the frequency of unwanted transactions. In this regard, it should be noted that, as pointed out by Joe Flom, in an analysis of mergers and acquisitions in the 1990s:

In 1991 there were only two domestic hostile deals announced In 1998 there were three announced hostile deals Such transactions substantially increased in number (fifteen transactions) . . . in 1999 In 1999, announced hostile deals worldwide . . . represent[ed] over 14% of all announced worldwide deal value. This was due, in no small measure, to a precipitous increase in European hostile deals.⁶³²

It seems likely that the current takeover rules in Delaware, and in states like Pennsylvania, are depressing the amount of hostile takeover activity. Indeed, it seems curious that in 1999, a year of extremely heavy merger and acquisition activity, there would be only 15 hostile transactions. It is inconceivable that the amount of hostile activity would have been lower in 1999 if the change of control concept had applied.

Mr. Hersch, of Davis, Polk & Wardwell, also says that he has "serious doubts . . . that the types of individuals you envision [for the change of control board] could be found."⁶³³ Just as there is a market for board members, I believe an active

⁶³⁰ Allen, *supra* note 447, at 2062-63.

⁶³¹ Letter from Marshall L. Small to Samuel C. Thompson, Jr., *supra* note 625.

⁶³² Joseph H. Flom, *Mergers and Acquisitions—The Decade in Review*, 54 U. MIAMI L. REV. 753, 761-62 (2000).

⁶³³ Letter from Dennis S. Hersch to Samuel C. Thompson, Jr., *supra* note 626.

market would develop for membership on change of control boards, particularly in view of the personal liability protection that these directors receive.⁶³⁴ There should be no shortage of competent business people, investment bankers, attorneys, and others from around the country who would be more than willing to serve on a change of control board.

Also, Mr. Hersch challenges the premise of this article concerning the inherent conflict corporate directors face in change of control transactions. On this point he says:

[T]he article cites a handful of cases in which directors were adjudged to have acted improperly. Far be it for me to defend the directors of Trans Union or Revlon who clearly did not act in a responsible manner.

The problem I have is that you extrapolate from a small number of cases a proposal that ignores the very fine work done by the overwhelming majority of corporate boards in change of control transactions. I have little doubt that it could be empirically demonstrated that a far greater number of these transactions are completed without legal challenge—or after successfully defending a challenge—than the other way around.

If my own experience is a relevant yardstick, I think you are generally incorrect in your premise that directors do not deal well with conflicts.⁶³⁵

He goes on to point out several transactions in which he was involved that demonstrate the effectiveness of the current board structure.⁶³⁶

I do not doubt that the current system works well in many cases, and I have no doubt that a “far greater number of these transactions are completed without legal challenge—or after successfully defending a challenge—than the other way around.”⁶³⁷ This does not mean, however, that in such successful deals the target’s shareholders have received the consideration to which they are entitled. Further, this says nothing about the number of deals that do not happen under the cur-

⁶³⁴ See *supra* part III.F.

⁶³⁵ Letter from Dennis S. Hersch to Samuel C. Thompson, Jr., Letter, *supra* note 626.

⁶³⁶ *Id.*

⁶³⁷ *Id.*

rent rules because of the depressing effect of defensive tactics like the poison pill.

The bottom line is that while I have great respect for the professionals who have given me their critiques, I still believe that the change of control board concept would significantly improve the governance of the merger and acquisition process.

X. CONCLUSION

Under the proposal here, a publicly-held corporation that becomes the target of a merger or acquisition would, unless the public shareholders elected-out, be subject to the change of control provisions of proposed Section 14A of the Securities Exchange Act of 1934. Thus, a uniform federal rule would apply to all such corporations.

Under Proposed Section 14A, a change of control board for a target corporation would be appointed at the time the target becomes the subject of a possible change of control transaction, whether an arm's-length merger or acquisition, a management buyout, a hostile tender offer, or a freezeout. The change of control board would have complete authority to make all board decisions for the target relating to the transaction, including the implementation of defensive tactics, such as the adoption of poison pills and the making of golden parachute payments. The change of control board would likely consult closely with the current board and the senior management of the target, and one of the members of the change of control board could be a member of the regular board, provided he or she was otherwise qualified.

The members of the change of control board would be appointed by the Change of Control Official, a nonpolitical appointee of the SEC. In making the appointments, the Change of Control Official would be required to make an *ex ante* decision that the members of the board are truly independent and have the requisite experience in the merger and acquisition process.

Because of this independence and experience, the change of control board would be subject to one governance standard, the business judgment rule, without respect to the type of transaction. There would be no need for separate governance standards for the four different types of change of control transac-

tions as is the case under current Delaware law and as proposed in the Corporate Governance Project.⁶³⁸

The proposal here is much more limited than proposals of Professor Cary and others for a federalization of corporate law. Since the shareholders can elect not to have the provision apply or elect to have it apply in only limited circumstances such as in hostile tender offers, this proposal offers shareholders an additional set of governance rules, thereby increasing the competition for such rules. Also, even after the appointment of a change of control board, the shareholders could, pursuant to SEC rules, elect to dissolve the change of control board and return to governance by the corporation's regular board or another board.

The justification for this proposal is simple. As recognized in several cases involving all types of mergers and acquisitions in the arm's length merger in *Van Gorkom*, the management buyout in *Hanson Trust*, the tender offer defensive tactics in *Revlon* and the freezeout merger in *Weinberger*, the conflicts facing a target's board, including independent directors, in mergers and acquisitions often lead to decisions that do not maximize shareholder welfare. Also, these same cases illustrate that directors who may be proficient at making entrepreneurial decisions may not have the requisite skill to make decisions that maximize shareholder value in mergers and acquisitions.

The change of control board addresses these two defects in the current process by ensuring the appointment of board members who are both conflict free and knowledgeable. The proposal is designed to ensure that the directors guiding the target through the merger and acquisition process act in the sole interest of promoting the welfare of the target's shareholders and where appropriate, other constituencies.

The cost associated with the change of control board should be de minimis and the benefits to shareholders great. Also, there should be substantial collateral benefits, including: (1) the preemption of state takeover laws, (2) the elimination of the cumbersome appraisal process, (3) the inapplicability of the provisions of Internal Revenue Code dealing with golden parachutes and greenmail payments, and (4) the elimination of the need for applying liability rules to the change of control direc-

⁶³⁸ CORPORATE GOVERNANCE PROJECT, *supra* note 2.

tors. Since those directors would be conflict free and knowledgeable, it would indeed be the rare case when their actions would not be protected by the business judgment rule. Thus, there should be a substantial decrease in merger and acquisition litigation. In this connection, Professors Bebchuk and Ferrell have recently noted that "Delaware might purposely be maintaining a legal regime that encourages litigation. Delaware's corporate lawyers, an important interest group in Delaware, benefit from more, rather than less, litigation."⁶³⁹

The change of control board will not deter tender offers, and, therefore, will not protect inefficient managers. The change of control board should facilitate the movement of corporate assets to their most productive uses and, therefore, should promote economic efficiency in the market for corporate control.

The only effective way to adopt the change of control board is through federal legislation, because it could not be expected that state legislatures would uniformly adopt this provision.⁶⁴⁰ Thus, there is a strong theoretical case for the adoption of a federal law mandating a change of control board, subject to the right of a corporation's independent shareholders to elect not to have the provision apply or to apply in limited circumstances.

Moreover, as reflected in the study by Professors Bradley and Schipani of the impact of section 102(b)(7)⁶⁴¹ and in the studies surveyed by Professor Lin involving poison pills and other aspects of mergers and acquisitions,⁶⁴² the current state of the empirical evidence supports the adoption of this proposal. If the relaxed liability exposure provided by section 102(b)(7) reduces shareholder welfare as found by Professors Bradley and Schipani, then the mandating of conflict-free and knowledgeable directors to deal with the merger and acquisition process should increase shareholder welfare.

⁶³⁹ Bebchuk & Ferrell, *supra* note 3, at 1191 (footnote omitted).

⁶⁴⁰ See, e.g., Carney, *Competition for Corporate Charters*, *supra* note 472.

⁶⁴¹ Bradley & Schipani, *supra* note 372.

⁶⁴² Lin, *supra* note 438, at 930-37. See Part V.

APPENDIX

PROPOSED SECTION 14A
OF THE SECURITIES EXCHANGE ACT OF 1934

CHANGE OF CONTROL BOARD

Proposed Statute	Comments
Section 14A	
(a) <i>Affected Issuers.</i> Unless the public shareholders vote to elect-out under Section 14A(o), or pursuant to rules promulgated under Section 14A(p) the corporate issuer is exempted from the application of this section, this section applies upon the happening of a trigger event, as defined in Section 14A(b), with respect to any domestic corporate issuer that has more than \$10 million in assets and underlying common stock (as defined in regulations) held by at least 500 persons. Such corporate issuers are referred to herein as "public corporations," and public corporations with respect to which a trigger event has occurred are referred to herein as "affected issuers."	Affected issuers are domestic publicly held corporations with respect to which a trigger event, as defined in Section 14A(b) below, has occurred. See Part III.B.
(b) <i>Trigger Events.</i> A trigger event shall occur if: (1) <i>Arm's Length Mergers, Management Buyouts and Freezeouts.</i> The board of directors of a public corporation receives a bona fide proposal (1) to engage in a merger, consolidation or mandatory share exchange, whether effected directly or by means of a subsidiary, or (b) to purchase substantially all of such corporation's assets, or (c) to give the board's endorsement to a tender offer for a controlling position in such corporation, or (d) to engage in any other transaction having a similar effect;	Proposed Section 14A(b)(1) encompasses all forms of transactions proposed to the target's board, including proposals for arm's length transactions, for management buyouts and for freezeouts. See Part III.B.

(2) <i>Self Initiated Mergers and Acquisitions.</i> The board of directors of a public corporation initiates negotiations designed to lead to the acquisition of the corporation in a merger or acquisition transaction; (3) <i>Target of Tender Offer.</i> A public corporation becomes the subject of an unsolicited bona fide tender offer under section 14(d) for a controlling interest in such corporation; (4) <i>13D Filed.</i> A Schedule 13D is filed with respect to a public corporation and the purpose of the acquisition as reflected in Item 4 of Schedule 13D is or may be for the acquisition of a controlling interest in such corporation; (5) <i>Reverse Acquisition, De facto Merger.</i> In exchange for the equity securities or assets of another corporate issuer, a public corporation issues its underlying common stock (as defined in regulations) that upon issuance will amount to in excess of 50% of such corporation's outstanding voting common stock.	Proposed Section 14A(b)(2) encompasses merger and acquisition transactions that are initiated by the target's board as occurred in <i>Smith v. Van Gorkom</i>. See Part III.B. Adoption of Proposed Section 14A(b)(3) would not prevent an acquiror from making an unsolicited tender offer for a target, but as a result of the tender offer, a change of control board would be appointed for the target. See Part III.B. Pursuant to Section 13(d) of the 1934 Act, a Schedule 13D is required to be filed upon the acquisition of more than 5% of the stock of a public issuer. See Part III.B. Proposed Section 14A(b)(5) codifies one aspect of the <i>de facto</i> merger doctrine. Under this provision, Time, Inc. would have been required to appoint a change of control board for its initial proposed acquisition of Warner, because the Warner shareholders would have ended up owning 62% of the resulting company. See Part III.B.
(c) <i>Petition for Appointment of Change of Control Official.</i> (1) <i>Petition by Board of Directors.</i> Upon the happening of a trigger event as described in Section 14A(b), the board of directors of the affected issuer shall promptly petition the Change of Control Official (as described in paragraph (d) below) for appointment of a change of control board. (2) <i>Petition by SEC or Shareholders.</i> If the board of directors of an affected issuer does not promptly file such petition after the happening of a trigger event, then the Securities and Exchange Commission, or any shareholder or group of shareholders of the affected issuer owning at least 5% of the underlying common stock of the issuer may file such a petition.	It is the responsibility of the target's board to seek the appointment of a change of control board upon the happening of a trigger event. Proposed Section 14A(c)(2) gives the SEC and shareholders power to have a change of control board appointed if the board of directors fails to promptly act upon the happening of a trigger event. See Part III.C.

(d) *The Change of Control Official.*

(1) *Appointment.* The Change of Control Official shall be appointed by the Securities and Exchange Commission, with the concurrence of a majority of the members of the Federal Reserve Board. The appointment shall be made on non-political grounds, and the appointee must not be identified with any particular change of control theory or ideology. The Securities and Exchange Commission may appoint multiple Change of Control Officials who shall have responsibility for various sections of the country.

(2) *Duties.* The duties and responsibilities of the Change of Control Official shall include:

(i) Preparation of lists of qualified persons who are willing to serve as members of a change of control board.

(ii) Preparation of lists of qualified attorneys, investment bankers and other professionals who are willing to serve as advisers to a change of control board;

(iii) Selection of members of a change of control board as provided in Section 14A(e) below;

(iv) Consultation with change of control boards regarding the hiring by such boards of professional advisers, such as lawyers and investment bankers, and the administrative activities of such boards;

(v) Monitoring and evaluating the performance of each change of control board and its members; and

(vi) The performance of other functions as specified in the rules and regulations under this section.

The procedure under Proposed Section 14A(d)(1) for appointing the Change of Control Official is similar to that for appointment of United States Trustees in bankruptcy cases. However, the requirement of concurrence from the Federal Reserve Board is new. *See* Part III.C.

The duties and responsibilities of the Change of Control Official under Proposed Section 14A(d)(2) are similar to the duties and responsibilities of the United States Trustee in bankruptcy cases. *See* Parts III.C. and III.D.2.

(e) *Selection of Change of Control Board.*

Upon the receipt of a petition, the Change of Control Official shall promptly appoint a change of control board for the affected issuer. Such board shall consist of three persons unless in the sole judgment of the Change of Control Official it is appropriate under the circumstances to have more than three board members, but in no event shall more than five persons be appointed to a change of control board. In making the selection, the Change of Control Official shall make a determination that each board member is not, pursuant to regulations to be promulgated by the Securities and Exchange Commission, interested in the contemplated merger or acquisition. The Change of Control Official shall also give consideration to the member's experience in dealing with merger and acquisition transactions and where appropriate to the member's knowledge of the industry in which the affected issuer operates. The Change of Control Official may in appropriate circumstances appoint to the change of control board one member of the target's regular board who is otherwise qualified to serve. To insure protection under the business judgment rule set out in Section 14A(i)(4), the Change of Control Official should be satisfied that each member will make a proper inquiry, will act in good faith, and will make decisions that he or she rationally believes to be in the best interest of the corporation. The members of the change of control board shall continue in office until resigning or dissolution of the board under Section 14A(1).

The procedures in Section 14A(e) for selection of the members of the change of control board should minimize the risk of cronyism or political motivation in the selection process. *See* Part III.C.

(f) <i>Responsibilities and Authority of Members of a Change of Control Board</i> (1) <i>Basic Responsibilities.</i> The change of control board will have responsibility, pursuant to a majority of vote, for making all decisions normally within the scope of the authority of the affected issuer's board of directors relating in any way to a potential or actual merger or acquisition transaction with respect to such issuer, including (1) deciding, pursuant to the authority contained in paragraph (i)(1) below, whether to consider, accept or reject a proposal to enter into a merger or acquisition transaction; (ii) preparation of a proxy statement, information statement or other disclosure document for shareholders relating to any merger or acquisition transaction; (iii) preparation of the affected issuer's response to a tender offer on Schedule 14D-9; (iv) the making of severance payments conditioned on a change of control transaction (<i>i.e.</i>, golden parachutes), (v) the repurchase at a premium of the stock of the issuer from a potential acquirer (<i>i.e.</i>, greenmail), (vi) the implementation, pursuant to the authority contained in paragraph (i)(1), of defensive tactics, such as the issuance of poison pills, that may have the foreseeable effect of blocking an unsolicited tender offer, (vii) entering into lock-up agreements, such as share option and share exchange agreements, and asset option agreements, (viii) the payment of hello fees or goodbye (<i>i.e.</i>, termination) fees and (ix) any other matters relating to a merger or acquisition transaction.	Proposed Section 14A(e)(1) gives the change of control board complete control over all matters bearing on a change of control transaction. There would be no reason for a change of control board to issue a deadhand pill, and any deal protection devices adopted by the change of control board would be subject to the business judgment rule, thus eliminating the source of many disputes arising under the current system. <i>See</i> Part III.D.
(2) <i>Hiring of Professionals.</i> With the consent of the Change of Control Official, the change of control board may hire its own independent attorney, investment banker and any other professionals as required by the circumstances. (3) <i>Authority.</i> The change of control board shall have the same authority to act as the issuer's normal board consistently with the governing state law, the charter documents, and the by-laws of the affected issuer. Thus, a change of control board may, provided the applicable state law and charter documents permit, issue a poison pill, subject only to the business judgment rule set out in Section 14A(i). (4) <i>Cooperation of Regular Board.</i> The board of directors of the affected issuer and all officers and other employees of the affected issuer shall cooperate fully with the change of control board. In the event a court, upon petition by the change of control board, determines that the board of directors is not cooperating fully, the court shall have the authority to suspend the board and replace it with the change of control board.	It is crucial that the change of control board have the authority to retain its own independent professionals. <i>See</i> Part III.D. Proposed Section 14A only empowers the change of control board to take those actions that could otherwise be taken by the target's normal board of directors. <i>See</i> Part III.D. This type of provision is needed to force the target's board to cooperate. <i>See</i> Part III.D.

(g) <i>Compensation of Members of Change of Control Board.</i> The members of the change of control board shall be compensated by the affected issuer on a fee for services basis pursuant to rules and a periodically updated fee schedule promulgated by the Securities and Exchange Commission. In promulgating such rules, the Securities and Exchange Commission shall take into consideration such factors as the size of the parties, the complexity of the transaction and the level of fees that would be payable in the open market for comparable work for comparable companies. The members shall also be reimbursed for their reasonable expenses, pursuant to rules promulgated by the Securities and Exchange Commission.	This type of compensation arrangement should be both fair and acceptable to most potential members of a change of control board. <i>See</i> Part III.D.2.
(h) <i>Compensation of Professional Advisers.</i> (1) <i>Fee for Services.</i> The professional advisers to the change of control board will be compensated by the affected issuer on a fee for services basis pursuant to rules and a periodically updated fee schedule promulgated by the Securities and Exchange Commission. Professional advisers shall also be reimbursed for their reasonable expenses, pursuant to rules promulgated by the Securities and Exchange Commission. (2) <i>Contingent Compensation.</i> In appropriate cases pursuant to rules promulgated by the Securities and Exchange Commission and with the approval of the Change of Control Official, contingent fees may be paid to investment bankers that are responsible for adding significant value to the transaction for the affected issuer's stockholders.	This type of fee for services compensation arrangement might be objectionable to some investment bankers, but in appropriate cases, contingent fees could be paid under Section 14A(h)(2). <i>See</i> Part III.D.

(i) <i>Scope of Authority, Duty of Care and the Business Judgment Rule.</i> (1) <i>Scope of Authority.</i> The change of control board, in the exercise of its business judgment, may approve, reject or decline to consider a proposal to the affected issuer to engage in a merger or acquisition transaction and may take an action that has the foreseeable effect of blocking an unsolicited tender offer. (2) <i>Other Constituencies.</i> In the exercise of its business judgment, the change of control board may have regard for interests or groups (other than shareholders) with respect to which the affected issuer has a legitimate concern if to do so would not significantly disfavor the long-term interest of shareholders. (3) <i>Duty of Care.</i> In exercising his or her business judgment, each member of the change of control board has a duty to the affected issuer to perform his or her functions in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. The duty set forth above includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director reasonably believes to be necessary. In performing his or her functions, a director is entitled to rely on materials and persons in accordance with the principles in Sections 4.02 and 4.03 of the ALI Corporate Governance Project.	Section 14A(i)(1) adopts the standard set out in Sections 6.01(a) and 6.02(a) of the ALI Corporate Governance Project. <i>See Part III.E.</i> Section 14A(i)(2) adopts the view of Section 6.02(b)(1) of the ALI Corporate Governance Project regarding other constituencies. <i>See Part III.E.</i> Section 14A(i)(3) sets out the duty of care rule contained in Section 4.01(a) of the ALI Corporate Governance Project. <i>See Part III.E.</i>
(4) <i>Business Judgment Rule.</i> A member of a change of control board who makes a business judgment in good faith fulfills his or her duty under this section if: (a) he or she is not interested in the subject of the business judgment; (b) he or she is informed with respect to the subject of his or her business judgment to the extent he or she reasonably believes to be appropriate under the circumstances, and (c) he or she rationally believes that his or her business judgment was in the best interest of the corporation. (5) <i>Burden of Proof.</i> A person challenging the conduct of a member of the change of control board has the burden of proving by clear and convincing evidence that there has been a breach of the duty of care including the inapplicability of the business judgment rule as set forth in paragraph (4) above, and such person has the burden of proving that the breach was the legal cause of damage suffered by the corporation.	Proposed Section 14A(i)(4) adopts the business judgment rule as set forth in Section 4.01(c) of the ALI Corporate Governance Project. <i>See Part III.E.</i> The board's decision would be protected by the business judgment rule as long as a majority of the members approving the action is protected. Section 14A(i)(5) adopts the burden of proof provision of Section 4.01(d) of the ALI Corporate Governance Project, except a clear and convincing standard of proof rule applies for establishing that the business judgment rule is not available. <i>See Part III.E.</i>

(j) <i>No Personal Liability, Insurance and Indemnification.</i> (1) <i>No Personal Liability.</i> Absent proof by clear and convincing evidence that a member of a change of control board acted with an intent to defraud, no member of a change of control board shall have any personal liability for actions taken or not taken as a member of a change of control board. (2) <i>Insurance and Indemnification.</i> Upon the appointment of the change of control board the affected issuer shall, pursuant to rules promulgated by the Securities and Exchange Commission, promptly provide indemnification and insurance for the members of the change of control board. Such insurance and indemnification is to cover all actions taken in connection with the member's activities on the change of control board, except any actions amounting to fraud.	It is crucial that the members of the change of control board be protected from personal liability, except in the case of fraud. <i>See Part III.F.</i>
(k) <i>Arbitration in Majority Control Freezeouts.</i> If a controlling shareholder controls sufficient votes of the controlled corporation to unilaterally effectuate the acquisition by merger, sale of assets or otherwise, of all of the controlled corporation's stock or of substantially all of its assets, and the controlling shareholder and the change of control board for the controlled corporation do not, within the time period specified in rules promulgated by the Securities and Exchange Commission, reach a decision on the price and other terms for such transaction, then the price and other terms shall be determined pursuant to a binding arbitration proceeding in accordance with rules promulgated by the Securities and Exchange Commission.	Proposed Section 14A(k) is designed to eliminate a deadlock between the change of control board for a controlled sub and the controlling parent in a freezeout transaction in which the controlling parent has sufficient votes to unilaterally complete the transaction. <i>See Part III.G.</i>
(l) <i>Dissolution of Change of Control Board.</i> Once the affected issuer is no longer the subject of a proposed merger or acquisition, the change of control board shall petition the Change of Control Official to have the change of control board dissolved. If the change of control board does not, within a reasonable period, file such a petition, then such a petition may be filed by either the Securities and Exchange Commission or a shareholder or shareholders of the affected issuer owning at least 5% of the issuers outstanding common stock.	Once the change of control transaction is either abandoned or effectuated, there is no longer a need for a change of control board. <i>See Part III.H.</i>

(m) <i>Federal Jurisdiction and Preemption of State Law.</i> (1) <i>Federal Jurisdiction.</i> Any suits brought under this provision shall be brought in the appropriate federal district court, which generally shall be the district court for the district in which the affected issuer has its headquarters. Such district court shall have exclusive jurisdiction over the matter. (2) <i>Preemption of State Law.</i> The provision shall preempt all state statutes bearing on change of control transactions, including all state appraisal statutes. This preemption shall not apply to those provisions setting out normal shareholder voting procedures for change of control transactions. Thus, this provision preempts such items as control share statutes, business combination statutes, disgorgement requirements and other constituency statutes. The Securities and Exchange Commission shall promulgate regulations specifying those state statutes that are preempted. (3) <i>Preemption of Charter Documents.</i> This provision shall preempt all charter documents, by-laws and other contractual arrangements of an affected issuer bearing on merger and acquisition transactions, other than those provisions setting out normal shareholder voting procedures for such transactions. Thus, this provision preempts all golden parachute contracts, poison pills, fair price provisions and shark repellent provisions entered into by the corporation's regular board. The securities and Exchange Commission shall promulgate rules specifying those types of corporate provisions and contracts that are preempted.	Proposed Section 14A(m)(1) makes it clear that there is exclusive federal jurisdiction over the change of control board. <i>See Part III.I.</i> Proposed Section 14A(m)(2) makes it clear that this provision preempts all state appraisal statutes and all non-normal state statutes bearing on change of control transactions. <i>See Part III.I.</i> Proposed Section 14A(m)(3) clarifies that this provision preempts all non-normal corporate and contract provisions bearing on mergers and acquisitions. This ensures that the change of control board has plenary authority over such matters. <i>See Part III.I.</i>
(n) <i>Transition Rules.</i> (1) <i>Delayed Effective Date.</i> This provision shall be effective three months after the date of enactment. (2) <i>Voiding Contracts.</i> Upon the effective date of this provision all executory contracts of the corporation relating to matters within the jurisdiction of the change of control board, such as golden parachute contracts, poison pills, fair price provisions and shark repellent provisions shall be null and void.	Consideration could be given to grandfathering certain provisions for a limited period. <i>See Part III.K.</i>

(o) <i>Election Out.</i> The public shareholders of a corporation otherwise subject to this provision, which shareholders are in no way related to or controlled by the management of the corporation or a controlling shareholder, may, pursuant to rules and regulations promulgated by the Securities and Exchange Commission, elect not to have this provision or specified subsections of this provision apply to the corporation.	This provision permits the public shareholders, on their own initiative and without the influence of management or a controlling shareholder, to elect to have this provision or specified subsections of this provision not apply to the corporation. Thus, for example, the public shareholders could elect to have the provision apply only to hostile tender offers. Also, even after a change of control board is appointed, a target's shareholders may, pursuant to regulations promulgated by the SEC, elect to remove the change of control board. See Part III.N.
(p) <i>Exemption Pursuant to Rule.</i> The Securities and Exchange Commission may promulgate rules and regulations exempting certain corporate issuers from the application of this section where it appears that because of the structure of the ownership of such corporation or the fact that the corporation has just recently become a public corporation or any similar reason, it would be inappropriate to apply the change of control board concept to such corporation.	This provision permits the SEC to exempt certain domestic corporate issues from Section 14A. Such an exemption may apply if, for example, a controlling block of shares is held by a single individual or family or the corporate issuer has only recently become a publicly-held corporation and the managers or organizers of the corporation own a significant percentage of the stock. Thus, the exemption is designed to minimize the possibility that Section 14A would discourage closely-held corporations from doing initial public offerings.
(q) <i>Illegality.</i> It shall constitute a violation of the Act for any person or persons to make a non-bona fide tender offer or a non-bona fide merger or acquisition proposal to a public corporation for the purpose of causing a trigger event to occur and a change of control board to be appointed.	This provision is designed to prevent parties from attempting to trigger a change of control board for strategic purposes.

THINKING OUT LOUD ABOUT THE MYTH OF *ERIE*: PLUS A GOOD WORD FOR SECTION 1652

*Jerome A. Hoffman**

The ones I feel sorry for are the people who,¹ for several generations now, have paid sums at times in excess of \$150 apiece to be taught Erie Doctrine rather than the Rules of Decision Act.²

* Elton B. Stephens Professor of Law, the University of Alabama School of Law. A.B. 1962, University of Nebraska; J.D. 1965, University of Nebraska. Thanks to the University of Alabama Law School Foundation and the Elton B. Stephens Professorship, which have supported this undertaking in part. Thanks to section 1 of the Classes of 1999 and 2000 for living through this experience with me. Thanks to Beth Williams, J.D. 1998, University of Alabama, and Stephen Daniel Kaufmann, J.D. 2001, University of Alabama, for able research assistance. Thanks to my colleagues Tony Freyer, Wythe Holt, and Norman Singer for invaluable leads concerning legal history and statutory interpretation. Thanks to my colleagues, Timothy Hoff, Kenneth Randall, David Epstein, Jon Bruce, Norman Stein, Carol Rice, and James Garland, who generously responded to nascent drafts with invaluable reactions or to specific inquiries with helpful advice or sometimes both. Thanks to my colleague, Bill Brewbaker, who shepherds our faculty colloquium series, and to the many colleagues who participated in my colloquium presentation. Thanks to my staff assistant, Wanda Elliott, for kicking my computer when necessary and for other valuable assistance. And thanks yet again to The Preacher for his timeless admonition. *See Ecclesiastes* 1:9.

¹ With an appreciative nod to Professor John Hart Ely, in the 27th-anniversary year of John Hart Ely, *The Irrepressible Myth of Erie*, 87 HARV. L. REV. 693, 693 (1974), still the leading piece on "Erie doctrine."

² In its present incarnation, the Rules of Decision Act is found at 28 U.S.C. § 1652 (1994). *See infra* note 21 and accompanying text. The statute began its life as section 34 of the Judiciary Act of 1789, Act of Sept. 24, 1789, 1 Stat. 92. It became U.S.C. § 725 (R.S. § 721) circa 1875 and § 1652 in 1948. Over most of its life, speakers and writers have, at least from time to time, referred to it familiarly as the Rules of Decision Act. This study may relapse into that usage when, in local context, it seems natural to do so. It may also call it § 34, § 725, or § 721, when discussing sources that would have called it that.

I number myself among both the sinned against and the sinners. As I look back on my student days, I see *Erie Railroad v. Tompkins*³ taking its bows in the unwavering spotlight. I see *Swift v. Tyson*⁴ kneeling, head bowed, downstage left. United States Code Title 28, § 1652 must have appeared somewhere in the cast, I suppose, but I have no memory of it. I blush to say I have presented sources of law for federal courts to my own students in much the same way.

Rather than a grand unified theory for determining sources of law applicable to federal court decisions, we have a tediously elaborated "doctrine" for federal courts sitting in diversity. Obsessing as we have over this special case,⁵ we have created

³ 304 U.S. 64 (1938). The reader who wishes a brief refresher on *Erie*, see *infra* pp. 245-48.

⁴ 41 U.S. (16 Pet.) 1 (1842). The reader who wishes a brief refresher on *Swift*, see *infra* pp. 193-95, 203-05.

⁵ See, e.g., Allan Ides, *The Supreme Court and the Law to Be Applied in Diversity Cases: A Critical Guide to the Development and Application of the Erie Doctrine and Related Problems*, 163 F.R.D. 19 (1995); Charles E. Clark, *The Tompkins Case and the Federal Rules*, 1 F.R.D. 417 (1940) [hereinafter Clark 2]; Symposium, *Federal Trials and the Erie Doctrine*, 51 NW. U. L. REV. 338, 347-51 (1956); James R. Ahrens, *Erie v. Tompkins—The Not So Common Law*, 1 WASHBURN L.J. 343 (1961); Harold M. Bowman, *Unconstitutionality of the Rule of Swift v. Tyson*, 18 B.U. L. REV. 659 (1938); Lawrence Earl Broh-Kahn, *Amendment by Decision—More on the Erie Case*, 30 KY. L. REV. 3 (1941); Lawrence Earl Broh-Kahn, *Uniformity Run Riot—Extensions of the Erie Case*, 31 KY. L.J. 99 (1943); Edmond N. Cahn, *Local Law in Federal Taxation*, 52 YALE L.J. 799 (1943); Michael H. Cardozo, IV, *Federal Taxes and the Radiating Potencies of State Court Decisions*, 51 YALE L.J. 783 (1942); Charles E. Clark, *Procedural Aspects of the New State Independence*, 8 GEO. WASH. L. REV. 1230 (1940); Charles E. Clark, *Professor Crosskey and the Brooding Omnipresence of Erie v. Tompkins*, 21 U. CHI. L. REV. 24 (1954) [hereinafter Clark 4]; Charles E. Clark, *State Law in the Federal Courts: The Brooding Omnipresence of Erie v. Tompkins*, 55 YALE L.J. 267 (1946) [hereinafter Clark 3]; Kenneth C. Cole, *Erie v. Tompkins and the Relationship Between Federal and State Courts*, 36 AM. POL. SCI. REV. 885 (1942); Arthur L. Corbin, *The Laws of the Several States*, 50 YALE L.J. 762 (1941); C. Sherman Dye, *Development of the Doctrine of Erie Railroad v. Tompkins*, 5 MO. L. REV. 193, 211 (1940) (citing many lower federal court opinions); Ely, *supra* note 1; Richard D. Freer, *Erie's Mid-Life Crisis*, 63 TUL. L. REV. 1087 (1989); Richard D. Freer, *Some Thoughts on the State of Erie After Gasperini*, 76 TEX. L. REV. 1637 (1998); Henry J. Friendly, *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U. L. REV. 383 (1964); Herbert F. Goodrich, *Mr. Tompkins Restates the Law*, 27 A.B.A. J. 547 (1941); Maxwell H. Herriott, *Has Congress the Power to Modify the Effect of Erie Railroad Co. v.*

Tompkins?, 26 MARQ. L. REV. 1 (1941); Alfred Hill, *The Erie Doctrine and the Constitution*, 53 NW. U. L. REV. 427 (1958) [hereinafter Hill]; Alfred Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013 (1953); Harold W. Horowitz, *Erie R.R. v. Tompkins—A Test to Determine Those Rules of State Law to Which Its Doctrine Applies*, 23 SO. CAL. L. REV. 204 (1950); Robert H. Jackson, *The Rise and Fall of Swift v. Tyson*, 24 A.B.A. J. 609 (1938); Arthur John Keefe, John J. Gilhooley, George H. Bailey & Donald S. Day, *Weary Erie*, 34 CORNELL L.Q. 494 (1949); Philip B. Kurland, *Mr. Justice Frankfurter, The Supreme Court and the Erie Doctrine in Diversity Cases*, 67 YALE L.J. 187 (1957); Irvin Long, *A Warning Signal for Municipal Bondholders: Some Implications of Erie Railroad v. Tompkins*, 37 MICH. L. REV. 589 (1939); Charles T. McCormick & Elvin Hale Hewins, *The Collapse of "General" Law in the Federal Courts*, 33 ILL. L. REV. 126 (1938); Edmund M. Morgan, *Choice of Law Governing Proof*, 58 HARV. L. REV. 153, 171-89 (1944); Covey T. Oliver, *The Nature of the Compulsive Effect of State Law in Federal Tax Proceedings*, 41 CALIF. L. REV. 638 (1953); John J. Parker, *Erie v. Tompkins in Retrospect: An Analysis of Its Proper Area and Limits*, 35 A.B.A. J. 19 (1949); Leonard V. Quigley, *Congressional Repair of the Erie Derailment*, 60 MICH. L. REV. 1031 (1962); Martin H. Redish & Carter G. Phillips, *Erie and the Rules of Decision Act: In Search of the Appropriate Dilemma*, 91 HARV. L. REV. 356 (1977); Albert J. Schweppe, *What Has Happened to Federal Jurisprudence?*, 24 A.B.A. J. 421 (1938); Samuel H. Sibley, *Delimitations of Erie Railroad Co. vs. Tompkins*, 29 KY. L.J. 172 (1941); Frank W. Snapp, *The Law Applied in the Federal Courts*, 13 LAW & CONTEMP. PROB. 165 (1948); Allen R. Stein, *Erie and Court Access*, 100 YALE L.J. 1935 (1991); Edward S. Stimson, *Swift v. Tyson—What Remains? What Is (State) Law?*, 24 CORNELL L.Q. 54 (1938); Lehan Kent Tunks, *Categorization and Federalism: "Substance" and "Procedure" after Erie Railroad v. Tompkins*, 34 ILL. L. REV. 271 (1939); Allan D. Vestal, *Erie R.R. v. Tompkins: A Projection*, 48 IOWA L. REV. 248 (1963); Paul A. Wolkin, *Conflict of Laws in the Federal Courts: The Erie Era*, 94 U. PA. L. REV. 293 (1946); Sergei S. Zlinkoff, *Erie v. Tompkins: In Relation to the Law of Trade-Marks and Unfair Competition*, 42 COLUM. L. REV. 955 (1942); Note, *After Erie Railroad v. Tompkins: Some Problems in "Substance" and "Procedure,"* 38 COLUM. L. REV. 1472 (1938); Note, *Application by Federal Courts of State Rules on Conflict of Laws*, 41 COLUM. L. REV. 1403 (1941); Arthur Bergner & Paul C. Szasz, Comment, *Erie Limited: The Confines of State Law in the Federal Courts*, 40 CORNELL L. Q. 561 (1955); Note, *Inapplicability of Erie v. Tompkins to Suits Involving Commercial Paper Issued by the United States*, 43 COLUM. L. REV. 520 (1943); Note, *Congress, the Tompkins Case, and the Conflict of Laws*, 52 HARV. L. REV. 1002 (1939); Arthur L. Corbin, Note, *The Common Law of the United States*, 47 YALE L.J. 1351 (1938); T.A. Cowan, Comment, *Constitutional Aspects of the Abolition of Federal "Common Law,"* 1 LA. L. REV. 161 (1938); Note, *Developments in the Doctrine of Erie Railroad Co. v. Tompkins I*, 9 U. CHI. L. REV. 113 (1941); Note, *Developments in the Doctrine of Erie Railroad Co. v. Tompkins II*, 9 U. CHI. L. REV. 308 (1942); Earl E. Eisenhart, Jr., Note, *Federal Decisional Law Independent of State Common Law since Erie R.R. Co. v. Tompkins*, 9 GEO. WASH. L. REV. 465 (1941); Note, *Exceptions to Erie v. Tompkins: The Survival of Federal Common Law*, 59 HARV. L. REV. 966 (1946); Note, *The Rise and Fall of Swift v.*

a complicated conceptual framework for it alone, letting the rest of what ought to fit within a comprehensive framework fall around it like conceptual debris. We address "choice of law in diversity cases" and "federal common law" at different places in our accounts⁶ and fashion a different mental routine for each.⁷ We suggest rules by which to determine when we must defer to the image of section 1652 reflected from the rippled pool of judicial precedent and when we need not consider it at all.⁸ We let important things go largely without saying or tuck them away where they are overlooked or taken randomly for granted.⁹ Seldom, if ever, it seems, does anyone suggest that we look to section 1652 first, that we read and apply its very words whenever we seek a controlling rule of decision in federal court.

Overlooking the statute is, it seems, very American, very

Tyson, 22 MINN. L. REV. 885 (1938); Harry Shulman, Note, *The Demise of Swift v. Tyson*, 47 YALE L.J. 1336 (1938); Note, *State Trial Procedure and the Federal Courts: Evidence, Juries, and Directed Verdicts under the Erie Doctrine*, 66 HARV. L. REV. 1516 (1953); Comment, *Substance and Procedure under the Doctrine of Erie Railroad Co. v. Tompkins*, 30 TEX. L. REV. 600 (1952); Halsey Taft Tichenor, III, Note, *Federal Procedure: The "Outcome" Test Applied in Actions Based on Diversity of Citizenship*, 35 CORN. L.Q. 420 (1950); Note, *Erie R.R. Co. v. Tompkins Limited Solely to Diversity of Citizenship Cases*, 38 VA. L. REV. 680 (1952).

⁶ See, e.g., ERWIN CHERMERINSKY, *FEDERAL JURISDICTION* 294-311 (1989) (discussing choice of law in diversity cases); see *id.* at 331-64 (discussing federal common law).

⁷ See, e.g., LARRY L. TEPLY & RALPH U. WHITTEN, *CIVIL PROCEDURE* 399-460 (1994) ("Erie doctrine"); see *id.* at 467-77 (discussing "federal common law").

⁸ See, e.g., Ely, *supra* note 1, at 698:

[W]here there is no relevant Federal Rule of Civil Procedure or other Rule promulgated pursuant to the Enabling Act and the federal rule in issue is therefore wholly judge-made, whether state or federal law should be applied is controlled by the Rules of Decision Act, the statute construed in *Erie* and *York*. Where the matter in issue is covered by a Federal Rule, however, the Enabling Act—and not the Rules of Decision Act itself or the line of cases construing it—constitutes the relevant standard.

Id. at 698.

⁹ See, e.g., *Campbell v. Haverhill*, 155 U.S. 610, 616 (1895) (explaining that the Rules of Decision Act "itself neither contains nor suggests . . . a distinction" between federal-question cases and diversity cases). Cf. *Holmberg v. Armbrrecht*, 327 U.S. 392 (1946).

common law—or so our continental European cousins might say.¹⁰ In their view, as I understand it, a court must, at each new invocation, start afresh with the controlling statute.¹¹ A

¹⁰ See, e.g., Mary Ann Glendon, Comment, in ANTONIN SCALIA, A MATTER OF INTERPRETATION, 95, 107 (1997) (“[Civil lawyers] . . . find it hard to understand why constitutional law courses and materials [used in American law schools] typically begin, not with a study of the language and design of the Constitution, but with a case.”).

Very common law, our Louisiana cousins might say, but not, in their view, entitled to wrap itself in the flag. See, e.g., Joachim Zekoll, *The Louisiana Private-Law System: The Best of Both Worlds*, 10 TUL. EUR. & CIV. L.F. 1 (1995); Konrad Zweigert & Hans-Jürgen Puttfarken, *Statutory Interpretation—Civilian Style*, 44 TUL. L. REV. 704 (1970).

¹¹ I understand this to be an abridgment of civil law statutory interpretation. Wolfgang Heyde explains the German legal perspective:

Binding law in the sense of English case law, formed on the basis of the decision-taking practice of the courts (“rule of precedent”) is in principle anathema to the German legal system. Nevertheless “judicial law-making”—commonly referred to as the propagation of the law by the judges—also has its own part to play in Germany. Some legal provisions are extremely abstract and drafted in a very general way, and it can be very difficult to apply them to individual cases. Very often, abstract terms must first be defined, brought to life and given a specific meaning by the courts. . . . The standards developed in the decisions taken on these and similar principles by the higher courts belong to the sphere of judicial law-making. In addition, cases are conceivable in which gaps arise in statutes, and consequently there is no rule to cover a specific eventuality. In such instances it can become necessary for a particular judge to fill that gap by supplementing the law himself. For example, he can apply a different statute *mutatis mutandis* (analogously), thereby further elaborating the idea which it embodies.

In cases of this type, genuine judicial law-making takes place when the principle concerned is adopted into constant decision-taking practice. With the exception of customary law, this form of the law is not generally binding, as binding precedents do not exist under German law. Decisions have binding force only in the individual case to which they relate. In practice, the decisions of the higher courts do have a strong influence on practice in the lower courts, especially where individual questions on consistent decision-taking practice are involved. Generally speaking, the lower courts comply with the principles of law established in decisions of the higher courts. As a rule, the higher courts also tend to adhere to their own previous decisions, thus in many instances causing the decisions to become binding in character.

WOLFGANG HEYDE, JUSTICE AND THE LAW IN THE FEDERAL REPUBLIC OF GERMANY 18-19 (C.F. Müller Juristischer Verlag, Heidelberg 1994). Some, however, have taken the abridgment seriously. See Zekoll, *supra* note 10, at 29 (explaining that

court does not start with what it or another court has said about the statute in a different factual context on a former occasion.¹² It goes back to the statute itself and holds it up anew to the facts of the case now under consideration, a practice traceable, perhaps, to the time of the Emperor Justinian.¹³ How different has been the lot of the Rules of Decision Act, surely a candidate for "Statute Most Likely to Be Ignored" in a polity whose ancestral lights resolutely overrode the plain meaning of statutes in derogation of the common law.

What follows is a thought experiment, an adventure in alternative histories. What if things had been different? What if the Rules of Decision Act had come down to us by way of a civilian tradition of respect for statutes, rather than a common law tradition of neglect? I do not challenge our Anglo-American reverence for precedent. Nor do I propose indoctrinating our students in heresies only fit for a world different than the world in which they must succeed. I propose only to muse

"[t]he Louisiana Supreme Court also shows devotion to these values. In several of its more recent decisions, it has admonished lower courts to base their decisions on applicable statutory provisions rather than on previously decided cases.") Nevertheless, as we move towards greater respect for enacted law, the civilians are, it seems, moving towards greater respect for judicial precedent.

¹² But see Zweigert & Puttfarcken, *supra* note 10, at 715-18. Indeed, I have as yet found no bright line between common law and civilian hermeneutics. Cf. *Graves v. New York*, 306 U.S. 466, 491 (1939) (Justice Frankfurter said, "The ultimate touchstone of constitutionality is the Constitution itself, and not what we have said about it."). Frankfurter said this, of course, about constitutional interpretation, not statutory interpretation, about which Professor Levi has said, "The problem of stare decisis where a constitution is involved is therefore an entirely different matter from that in case law or legislation." Edward H. Levi, *An Introduction to Legal Reasoning*, 15 U. CHI. L. REV. 501, 541 (1948).

¹³ See FRIEDRICH KARL VON SAVIGNY, *SYSTEM DES HEUTIGEN RÖMISCHEN RECHTS* 296-304 (2. Neudruck der Ausgabe Berlin 1840; Scientia Verlag Aalen 1981). Justinian declared: "Hinfert mögen also alle lächerliche Zweifel schwinden, und es soll der Kaiser als einziger Gesetzgeber nicht nur, sondern auch als einziger Interpret anerkannt werden." *Id.* at 302. Of this decree, Savigny said: "In dieser Verordnung liegen zwei ganz verschiedene Sätze: erstlich die verbindliche Kraft der Kaiserlichen Auslegung, in welcher Form sie auch geschehe; zweitens das Verbot jeder Privatauslegung. Dieses letzte ist nun eigentlich das Neue und Wichtige" *Id.* at 303 (*emphasis added*). Thus, the progenitors of code methodology fashioned it, perhaps, less out of respect for theory, than out of concern for their heads.

about what might have been and perhaps, what might still be.

Looking afresh at section 1652, we might find a thread to follow out of Erie doctrine's labyrinth.¹⁴ Suppose, for example, that the Supreme Court began to take section 1652 seriously. The back-to-the-statute *provide-or-require* mandate elaborated hereinafter might comfortably subsume all that's legitimate about what presently bears the name, "Erie doctrine."¹⁵ When an act of Congress purports to *provide* a certain rule of decision, the constitutional concerns embodied by Erie doctrine may play a part in testing the act's constitutionality. When an act of Congress purports only to *require* a certain rule of decision, the constitutional concerns embodied by Erie doctrine may also play a part in answering the antecedent question whether the act really does *require* a rule of decision that would conflict with state law. When a rule or regulation authorized by an act of Congress¹⁶ purports to *provide* or *require* a certain rule of decision, the constitutional concerns embodied by Erie doctrine may play parts at additional decision points. That is, they may bear upon (1) whether Congress could constitutionally *provide* or *require* the rule of decision contended for and (2) whether the rule of decision contended for lies within the authority granted by Congress to the rulemaking body. Certainly, the Justices cannot abandon their own histories and the community's expectations. However, their opinions have, from time to time, employed in all but name the kind of reasoning proposed here; they could see themselves as creating nothing new.¹⁷ They need not dramatically renounce six decades of

¹⁴ See, e.g., Ides, *supra* note 5, at 19 ("Poor us; we're still muddling through the arcane abstractions known as the *Erie* doctrine.").

¹⁵ See *infra* pp. 245-56.

¹⁶ 28 U.S.C. § 2071 (1994) (rule-making authority conferred).

¹⁷ See, e.g., ANTONIN SCALIA, A MATTER OF INTERPRETATION 138 (1997) ("Originalism, like any other theory of interpretation put into practice in an ongoing system of law, must accommodate the doctrine of *stare decisis*; it cannot remake the world anew."). But cf. Cleveland v. United States, 329 U.S. 14, 28 (1946) (Murphy, J., dissenting) ("*Stare decisis* certainly does not require a court to perpetuate a wrong for which it was responsible, especially when no rights have accrued in reliance on the error."). And consider the example set by the Court in *Erie* itself. See Levi, *supra* note 12, at 540 ("Even when such [legislative] correc-

experimental verbiage. Our experience with the consequences of trashing *Swift* in *Erie* counsels against that. They need only let the past's experiments molder away in benignly neglected retirement. The principles of parcelled power and equal protection underlying, but not innovated by, *Erie* doctrine¹⁸ could live on to monitor judicial decisions about the choices of enacted texts indicated by section 1652. Beyond that, a freshly contemporary understanding of section 1652 and its potentially central position in 21st-century federalism might move Congress to re-enact it in 21st-century American English for 21st-century American judges.¹⁹

I. PREVIEWING SECTION 1652

A. *The Rules of Engagement*

Donning the unaccustomed vestments of civilians,²⁰ let us

tion could be had, the Constitution might justify a change in position by the Court.”).

¹⁸ Recall Justice Harlan's allusion to “the principles which ultimately are the wellsprings both of the Rules of Decision Act and of the *Erie* doctrine.” *Commissioner v. Estate of Bosch*, 387 U.S. 456, 477 (1966) (Harlan, J., dissenting).

¹⁹ Modifying a *provide-or-require* understanding of § 1652 to accommodate our concern for judicial precedent might produce an amended statute reading as follows:

If the United States Constitution, a valid treaty of the United States, a valid act of Congress, [or] a rule adopted by and within the authority of a valid act of Congress, **or a judicial interpretation of any of these** provides or requires a rule of decision for the question presented in any court of the United States, that court shall apply that rule of decision. If not, it shall apply the rule of decision provided or required by the forum state's law.

The boldface adjustments undertake to give judicial precedent its due. Recall Professor Corbin's conception of judicial precedent's due, “But even if we have a decision of the highest court, with a clear-cut opinion laying down a definite rule, our judicial system is such that the rule there stated may not be followed tomorrow. The decision binds the litigants. It binds nobody else.” Corbin, *supra* note 5, at 772.

²⁰ Once upon a time, my boss and mentor, Philip K. Verleger, of McCutchen, Black, Verleger, & Shea, a scholar's lawyer, sent me to the library to find a certain rule of decision for him. I returned, happily, with a California statute squarely on point. He immediately sent me back to find a California case holding that the statute meant what it said. Thus have young common lawyers been

begin with the very words of the statute, "[t]he laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."²¹

For the purposes of this inquiry, let us allow ourselves only the textual and contextual tools of civil law statutory interpretation, depriving ourselves for the time being of its historical and teleological tools.²² In parsing the text, let us suffer syntax, grammar, and diction to affect us as they might affect the in-court behavior of a federal judge, not as they might affect the out-of-court behavior of a private person. In reading the text in context, let us attempt to look at the language of both section 1652 and "the code" surrounding it as if the 210 years of their histories had never happened. Let us also take a certain liberty with code methodology by defining "the code," for present purposes, to include constitutional texts as well as statutory texts.²³ Let us put off for now the understandings

taught to disregard statutes.

²¹ 28 U.S.C. § 1652 (1994). From its original enactment until 1948, it read as follows:

The laws of the several states, except where the Constitution, treaties or statutes of the United States shall otherwise require or provide, shall be regarded as rules of decision in *trials at common law* in the courts of the United States in cases where they apply.

Id. (emphasis added). According to some, amendment has not changed the meaning of the statute. See, e.g., 19 WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 4502 at 4 & n. 6 (2d ed. 1996). It must at least, however, have broadened the scope of the statute's application from "trials at common law" alone to include (1) what had formerly been proceedings in equity and (2) all of the modern pre- and post-trial procedures implied in the term "civil actions" since the merger of law and equity. See, e.g., WILFRED J. RITZ, REWRITING THE HISTORY OF THE JUDICIAL ACT OF 1789, 143 (Wythe Holt & L.H. LaRue eds., 1989) ("If, as we have no reason to doubt, the phrase was used consistently in Section 34, the application of Section 34 is not to the whole judicial proceeding but only to the 'trial' part when testimony is taken in open court."). See also *supra* note 2 and accompanying text.

²² See, e.g., Winfried Brugger, *Legal Interpretation, Schools of Jurisprudence, and Anthropology: Some Remarks From a German Point of View*, 42 AM. J. COMP. L. 395, 396-404 (1994) (discussing methods of interpretation); Prof. Dr. Jörg Schmid, Lecture at the University of Fribourg, Fribourg, Switzerland (June 14, 1996).

²³ See Zweigert & Kötz, *supra* note 10, at 707 ("[T]raditional civil law

suggested by our legal historians²⁴ and any consideration of US-American language usages of the years around 1800.²⁵ To the extent we cannot exclude purpose from our minds, let us derive purpose from meaning, not meaning from hypothesized purpose. Let us follow these restrictive rules of engagement not because the excluded considerations will, in the final analysis, necessarily have become insignificant, but to control otherwise distracting variables in the experiment.

B. A Proposed Reading of Section 1652

You, my fellow experimenter, will decide for yourself where this process leads you. Permit me, in these next few pages, to report where playing by these rules has led me. Having undertaken to play by the rules, I understand the statute as follows:

If the United States Constitution, a valid treaty of the United States, a valid act of Congress, or a rule adopted by and within the authority of a valid act of Congress provides or requires a rule of decision for the question presented in any court of the United States, that court shall apply that rule of decision. If not, it shall apply the rule of decision provided or required by the forum state's law.

From text and contemporary context, I have derived definitions of terms. In doing so, I have consulted dictionaries and legal dictionaries, as a federal judge might do. Perhaps unavoidably, I have also consulted my own feel for American English as a lifetime user.

jurisprudence has focused mainly, if not exclusively, on the codes, and all civilian methodology including legal interpretation is, basically, code methodology.”).

²⁴ See, e.g., WILFRED J. RITZ, *REWRITING THE HISTORY OF THE JUDICIARY ACT OF 1789* (Wythe Holt & L.H. LaRue eds., 1989); TONY A. FREYER, *HARMONY & DISSONANCE: THE SWIFT & ERIE CASES IN AMERICAN FEDERALISM* (1981); RANDALL BRIDWELL & RALPH U. WHITTEN, *THE CONSTITUTION AND THE COMMON LAW: THE DECLINE OF THE DOCTRINES OF SEPARATION OF POWERS AND FEDERALISM* (1977); 2 WILLIAM W. CROSSKEY, *POLITICS AND THE CONSTITUTION IN THE HISTORY OF THE UNITED STATES* (1953); Charles Warren, *New Light on the History of the Federal Judiciary Act of 1789*, 37 HARV. L. REV. 49 (1923).

²⁵ See, e.g., RITZ, *supra* note 24, at 80-97, 140-46.

1. Syntax and Grammar

This restatement of section 1652 has, some might say, reversed the statute's order of commands. The statute seems to say, "Choose state law, unless . . . ; then federal law." The restatement says, "Choose federal law, if . . . ; state law, if not." Notice, however, the way in which section 1652 nuances its apparent priorities. Half of the mandate for state law appears at the beginning of the sentence and the other half appears at the end. Between these halves appears the mandate for federal law.²⁶ If we are willing to say this syntactical feature means nothing, we raise a serious problem of interpretation. How do we decide which linguistic features have meaning and which do not?²⁷ Perhaps at least as much because of its structure as for reasons hidden even from myself, I understand the statute to say, "In default of federal law, choose state law," not, "In default of state law, choose federal law." In cases not falling within the statute's exception, there can be no default of state law—if not established, then projected or predicted. To interpret the statute otherwise would permit a third category of cases, one to which neither established state law nor established federal law would apply, leaving federal courts free to make up the law as they went along. This, some might say, is a mistake into which *Swift v. Tyson*²⁸ led us. Furthermore, my reading construes the statute to parallel the structure and apparent import of the 10th Amendment,²⁹ a part of "the code" to which section 1652 belongs.

²⁶ See NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION, Vol. 2A, § 47.11 (5th ed. 1992) (discussing interpretation of exceptions within statutes).

²⁷ *Id.* § 47.02(4) ("[N]o part of the act is superior to any other part").

²⁸ 41 U.S. (16 Pet.) 1 (1842).

²⁹ "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X. The citations to the Tenth Amendment throughout this piece are not meant to endorse a "state enclave" theory of parcelled power. See Ely, *supra* note 1, at 700-06 (discussing enclave theory).

2. Definitions and Interpretations

A number of words and terms stand out, the definitions of which might, in this or that eventuality, become pivotal. Those words and terms, in order of appearance, are: *laws of the several states, or, Acts of Congress, require or provide, shall be regarded as, rules of decision, courts of the United States, and in cases where they apply.*³⁰ I shall propose definitions or interpretations for them all, but my eye falls first upon the formulation "require or provide," words unaccustomed to a starring role in the history of section 1652.

a. "Require or provide"

Although other potentially pivotal terms precede it in the statute, let us first focus unaccustomed attention on the words, "require or provide," which may well hold the key to an easier, less tortuous understanding of section 1652 than does Erie doctrine. A back-to-the-statute *provide-or-require* mandate might comfortably subsume all that is legitimate about what presently bears the name, "Erie doctrine."³¹

I do not read "provide" and "require" as having co-extensive meanings. To do so would violate my canons of simplicity and economy. Furthermore, section 1652 does not say "except where a provision of the Constitution or treaties of the United States or Acts of Congress otherwise require or provide." From this, I draw courage to contend that what rule of decision federal law *requires* can, indeed at least virtually must, be discerned by taking federally enacted texts whole,³² or at least as whole as our finite intellects will permit.

Section 1652 reads "require or provide."³³ I would have

³⁰ I understand that courts do not ordinarily volunteer definitions of terms upon which no present contention turns. Nor do they ordinarily attempt even to identify what counts as a "term" without the defining illumination of a contest.

³¹ See *infra* pp. 245-56.

³² The formula "enacted texts" appearing throughout this study includes a polity's constitution, treaties of a polity, acts of a polity's legislature, and rules adopted by and within the authority of a valid act of a polity's legislature.

³³ See SINGER, *supra* note 26, § 47.16 (discussing interpretation of similar words which are grouped together).

written "provide or require," and I would feel more confident of my reading, if the statute agreed with me. Unless my faculty for self-observation fails me more completely than I fear, I put my preferred alternative first when suggesting a choice of possibilities. If my habit reflects common contemporary US-American English usage, then the priority of position assigned to "requires" speaks, to say the least, against subordinating it to "provides" or discounting it significantly towards zero. It suggests at least a nod to the reality that a statute may, during its lifetime, particularly decades and centuries after passage, have to provide answers for questions not foreseen by its typically fallible and clairvoyantly challenged authors. On the other hand, it may suggest too much for my thesis to bear, and I wish Congress would amend section 1652 to read "provide or require."³⁴

The United States Constitution, a treaty of the United States, an act of Congress, or a rule adopted by and within the authority of a valid act of Congress *provides* a certain rule of decision if the letter of some passage says so.³⁵ The United States Constitution, a treaty of the United States, an act of Congress, or a rule adopted by and within the authority of a valid act of Congress *requires* a certain rule of decision if the sense or "spirit"³⁶ of some provision or provisions so implies.³⁷

³⁴ See *id.* at § 47.35.

³⁵ See MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY at 940 (10th ed. 1993), "2: to make a proviso or stipulation <the constitution . . . ~s for an elected two-chamber legislature—*Current Biog*"; see also 40 WORDS & PHRASES 180 (explaining that "a statutory provision is any express enactment") (citing *City of Portland v. State Bank of Portland*, 214 P. 813, 107 Or. 267 (1923))."

Of course, a statute cannot speak for itself. As our civilian cousins would remind us, to hear a statute "saying so" is itself an act of interpretation. See, e.g., Zweigert & Kötz, *supra* note 10, at 713 ("Deciding a case on the basis of the plain meaning of a rule is, in terms of logic, a tautology; psychologically speaking, it is hypocrisy, for the judge who renders judgment on this ground pretends to give a reason for his decision, when actually he gives none."). We may define "provides" to correspond with, for example, the Swiss Civil Code's "nach Wortlaut." See SWISS CIVIL CODE 1, § A ("Das Gesetz findet auf alle Rechtsfragen Anwendung, für die es nach Wortlaut oder Auslegung eine Bestimmung enthält.") (emphasis added).

³⁶ See, e.g., SWISS CIVIL CODE art. 1, § A ("La loi régit toutes les matières

Others have anticipated the distinction made here. Justice Douglas did so, for example, when he said, in a different context, "Nor has Congress expressly made [i.e., *provided*] any such finding a prerequisite to citizenship. To hold that it is *required* is to read into the Act by implication."³⁸ That is, by only a slight extension of Justice Douglas's point, one or more provisions can, read whole, imply or inform the choice of a rule of decision. *A rule of decision REQUIRED by federal constitution, statute(s), and/or treaty(ies) need not itself come from a federal source; it may be a certain rule provided or required by forum state law, a competing rule also PROVIDED or REQUIRED by forum state law, or a rule PROVIDED or REQUIRED by the law of another state.*³⁹

Realists would, one supposes, say that a federal source *provides* or *requires* a rule of decision when the court with the last word so holds. To acknowledge this neither invites nor suggests "judicial activism." It simply recognizes the unavoidable in a polity expecting courts to apply the polity's enacted texts to the adjudication of cases and controversies. But this acknowledgment can satisfy only the judge whose realist creed has induced delusions of grandeur.⁴⁰ One who wears the robe in more than name will submit solicitously to the power of ideas transcending personal predilection. To say what those ideas should be, however, would exceed the scope of this inquiry.

Thus, I leave to the dons of this or that school of interpretation the "rules" for understanding what rule of decision the letter of any certain federal source *provides* in this or that

aux-quelles se rapportent *la lettre* [the letter] ou *l'esprit* [the spirit] de l'une de ses dispositions.") (emphasis added).

³⁷ We may define "requires" to correspond with, for example, the Swiss Civil Code's "nach . . . Auslegung." See *supra* note 35.

³⁸ *Girouard v. United States*, 328 U.S. 61, 64 (1946) (emphasis added); see also Keefe, Gilhooley, Bailey & Day, *supra* note 5, at 520 ("The federal court system is integrated where 'the Constitution, treaties or statutes of the United States' [citing the Rules of Decision Act] so provide or imply.").

³⁹ See *infra* pp. 191-92.

⁴⁰ The theory of legal realism, it has long seemed to me, operates at a level of discourse different from that at which the theory of legal positivism operates.

context. Should they disagree, we will have witnessed yet another warning against "the one-word, one-meaning fallacy"⁴¹ to which some schools seem more vulnerable than others. Likewise, I leave to them the prescription of mental disciplines for descrying what rule of decision the sense of federal sources, singly or in concert, *requires* in this or that context. Sometimes, as they might or might not agree, the sense of federal sources may *require* an interpretation to "fill the interstices"⁴² of federal law with "the rule that will best effectuate the federal policy."⁴³ Sometimes it may *require* a cumulative reading of several pieces of text from various sources. Or it may *require* reflection upon "the equity of the statute."⁴⁴

No matter what principles of interpretation federal judges employ, there may be no reason beyond force of habit to call all or any part of these judicial interpretations "federal common law."⁴⁵ According to this understanding of section 1652's *provide-or-require* mandate, the legitimacy of a federal judicial decision depends upon its relationship to federally enacted texts and the relationship of those texts to the question presented by the case at bar.

The application of section 1652's *provide-or-require* mandate will occupy most of this inquiry. Other words and terms may, however, play significant roles as well. Judges do not people a statute with wholesale definitions. They do it at retail,

⁴¹ HENRY M. HART, JR. & ALBERT M. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 1190 (William N. Eskridge, Jr. & Philip P. Frickey, eds., 1994).

⁴² *Kamen v. Kemper Fin. Servs.*, 500 U.S. 90, 98 (1991).

⁴³ *Textile Workers Union of Am. v. Lincoln Mills*, 353 U.S. 448, 457 (1957).

⁴⁴ See *infra* notes 59, 437 and accompanying text.

⁴⁵ See Justice Scalia's allusion to "so-called 'federal common law'" in *Boyle v. United Tech. Corp.*, 487 U.S. 500, 504 (1988). See also Note, *Erie Limited: The Confines of State Law in the Federal Courts*, 40 CORNELL L.Q. 561, 575 (1955) ("[T]hat the federal common law has reappeared in so many garbs should act as a warning. For these many common laws are by no means one, and they neither arise from the same need [or federally enacted text] nor do they serve the same purpose. . . . [T]here are many federal common laws which, *differing in their source*, may differ in their substance.") (emphasis added). Our legal historians must tell us how much of English common law derives ultimately from ancient statutes.

defining words and terms only when and as brought into contention in an unfolding case or controversy. Here, however, let us enjoy the nonjudicial luxury of anticipation, chastening our license with an awareness that, in the heat of litigative controversy, terms might emerge differently configured than suggested here.

b. "Or"

Section 1652 says "the Constitution *or* treaties of the United States *or* Acts of Congress."⁴⁶ In ordinary American English usage, the word "or" usually serves as a disjunctive. Can an honest interpreter of statutes argue for a conjunctive "or"? According to *Merriam-Webster's Collegiate Dictionary*, "or" is, in its fourth sense, "used in logic as a sentential connective that forms a complex sentence which is true when *at least one* of its constituent sentences is true—compare DISJUNCTION."⁴⁷ True, judges have taken one another to task for relying upon secondary dictionary meanings of pivotal terms,⁴⁸ but insisting upon a disjunctive definition of "or" for these two occurrences in section 1652 would effectively remove "treaty" and "Act of Congress" from the statute. That is, a treaty or act of Congress could never *provide* or *require* a rule of decision without the constitutional authorization upon which its validity depends.

Having defined these two uses of the word "or" as conjunctive, must I apply the same definition to the word "or" wherever else it appears in section 1652?⁴⁹ If so, my pivotal understanding of the term(s) "require *or* provide" comes under some pressure. There, as you may recall, I sneaked by the word "or"

⁴⁶ 28 U.S.C. § 1652 (1994) (emphasis added).

⁴⁷ MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY at 817 (10th ed. 1993) (emphasis added); see also *Honig v. Doe*, 484 U.S. 305, 334 (1988) (Scalia, J., dissenting) (reading non-disjunctive "or" in different context).

⁴⁸ See *Anderson v. Malloy*, 700 F.2d 1208, 1215 (8th Cir. 1983) (Gibson, J., dissenting in part) ("The majority opinion here reaches to the second dictionary definition of feasible in order to conclude that feasibility was controverted.").

⁴⁹ See Akhil Reed Amar, *Intratextualism*, 112 HARV. L. REV. 748 (1999) (promoting constitutional interpretation that "read[s] a contested word or phrase . . . in light of another passage . . . featuring the same (or a very similar) word or phrase.").

without fanfare, understanding it *sub silentio* in its disjunctive sense. Until advised otherwise by the gurus of statutory interpretation, both common law and civilian, I shall conclude that a word serving only as an intermediary between terms may bear different definitions in different local contexts.⁵⁰ I do see differences in local context that may justify differences in definition.⁵¹ The words "or" in "the Constitution *or* treaties of the United States *or* Acts of Congress" do not stand between terms possibly understood as synonyms. The word "or" in "require *or* provide" does. I chose the disjunctive for this "or" because of an aversion to the use of synonyms in statutes. I understand, on the other hand, that legislators might wish to put the intended scope of a term beyond quibble by enumerating the near equivalents falling within that scope. If so, however, legislators might better accomplish that by appending a definitions section.

c. "*Act of Congress*"

The United States Constitution, valid treaties of the United States, and valid acts of Congress appear as sources of federal rules of decision on the face of section 1652. I read "Act of Congress" to include rules adopted by and within the authority of valid acts of Congress. I cannot claim authorship of this idea. So far as I can tell, it belongs to others.⁵² In any case, it seems

⁵⁰ Whether this conclusion applies as well to the terms such words intermediate, I leave to abide the event. Consider, for example, the term "plaintiffs" in 28 U.S.C. § 1367(b) (the supplementary jurisdiction statute). One can understand that statute to require some different outcomes if one insists upon defining "plaintiffs" throughout as *parties who commence cases or controversies*, than if one defines "plaintiffs" in certain contexts as *parties who assert jurisdictionally challenged claims within cases or controversies*. How one draws the distinction implied between mere "words" and more exalted "terms" I leave also to abide the event.

⁵¹ See Schweppe, *supra* note 5, at 425 ("A word is presumed to be used in the same sense throughout a statute, unless the context plainly requires a different meaning."). Compare *Pampanga Sugar Mills v. Trinidad*, 279 U.S. 211, 218 (1928) ("In the absence of express restriction it may be assumed that a term is used throughout a statute in the same sense in which it is first defined.").

⁵² See Ronan E. Degnan, *The Law of Federal Evidence Reform*, 76 HARV. L. REV. 275, 288-89 (1962) ("Literally, the act designates as controlling sources of federal law only the Constitution, treaties and 'Acts of Congress.' But the authori-

to make good sense for rules (e.g., the Federal Rules of Civil Procedure) both authorized⁵³ and monitored⁵⁴ by Congress. Although deeper inquiry must await other occasions, and perhaps other enquirers, the idea would apply with commensurate reason, it seems, to agency rules and regulations. I understand that section 1652's history points, or may point, in a different

ty under which such rules would be made comes from acts of Congress, the enabling acts."); see also 2 CROSSKEY, *supra* note 24, at 820 ("This section [section 34 of the Judiciary Act of 1789, i.e., the Rules of Decision Act], standing by itself, might probably today be taken to comprehend matters of process, or procedure, as well as substance, in the "trials" it covered."); cf. Edmund M. Morgan, *Rules of Evidence—Substantive or Procedural?*, 10 VAND. L. REV. 467, 480 (1957) ("If these decisions mean that section 34 is still controlling with reference to procedural rules, they totally disregard the excepting clause."). I do disagree with Professor Morgan's formulation in one respect. Being within the excepting clause does not take a proffered rule of decision out from under § 1652. It controls the choice of certain federal rules of decision as certainly as it controls the choice of certain state rules of decision.

⁵³ 28 U.S.C. § 2072 (1994).

⁵⁴ 28 U.S.C. § 2074(a). See Rules Enabling Act of 1934, ch. 651, 48 Stat. 1064 (1933-34):

[Such rules prescribing] the forms of process, writs, pleadings and motions, and the practice and procedure in civil actions at law . . . shall take effect six months after their promulgation, and thereafter all laws in conflict therewith shall be of no further force or effect. Such united rules [merging law and equity] shall not take effect until they shall have been reported to Congress by the Attorney General at the beginning of a regular session thereof and until after the close of such session.

Concerning conclusions properly drawn from Congress's authority and opportunity to monitor, opinions have differed. Consider, for example, Justice Roberts's words in *Sibbach v. Wilson & Co.*: "The value of the reservation of the power to examine proposed rules, laws and regulations before they become effective is well understood by Congress. . . . That no adverse action was taken by Congress indicates, at least, that no transgression of legislative policy was found." 312 U.S. at 15-16 (1941). Compare that view with Justice Frankfurter's opinion in the same case:

[L]ittle significance attaches to the fact that the Rules, in accordance with the statute, remained on the table of two Houses of Congress without evoking any objection to Rule 35 and thereby automatically came into force. Plainly the Rules are not acts of Congress and can not be treated as such. Having due regard to the mechanics of legislation and the practical conditions surrounding the business of Congress when the Rules were submitted, to draw any inference of tacit approval from non-action by Congress is to appeal to unreality.

312 U.S. at 18 (Frankfurter, J., dissenting).

direction,⁵⁵ but I am ignoring history right now. Furthermore, as our continental cousins would remind us, history can inform us, even at times enthrall us, but it cannot bind us.⁵⁶

d. "Laws of the Several States"

I define "laws of the several states" to mean those texts regarded as rules of decision in and by the courts of the several states. Does the statute mean something different because it says "laws" rather than "law"? Note that I don't ask, "Why 'laws' rather than 'law'?" To do so might suggest an inquiry into Congress's intent, which I presently decline.⁵⁷ To my under-

⁵⁵ See *Wayman v. Southard*, 23 U.S. (10 Wheat.) 1, 24, 26 (1825) ("This section [34] has never, so far as is recollected, received a construction in this Court; but it has, we believe, been generally considered by gentlemen of the profession, as furnishing a rule to guide the Court in the formation of its judgment; not one for carrying that judgment into execution. . . . The 34th section, then, has no application to the practice of the Court, or to the conduct of its officer, in the service of an execution."); see also *infra* pp. 185-89.

⁵⁶ See Zweigert & Puttfarcken, *supra* note 10, at 712. "[T]he older a statute, the more legitimate is a method of interpretation which frees itself from the ideas of the historic legislator and attempts to find its meaning from different criteria based on the conditions of today." *Id.* at 712. "There are instances of code provisions, notably in the French *Code Civil*, which is the oldest of the most important codes still in force today, whose present meaning is the exact opposite of their original legislative intention." *Id.* at 715. Compare HART, *supra* note 41 ("a classic example of the process by which a statute eventually takes on a life of its own, governed by the evolving principles by which it has been interpreted rather than by any direct reference to original purpose, is the Statute of Frauds. By this time it matters little what actually was 'intended' individually or collectively by the members of the English Parliament of 1677, or, in this country, by the state legislature[s] which reenacted it.") Recall also Professor Corbin: "Any rule of law may regard itself lucky if it lives a hundred years. No centenarian should ever rule a nation, or a court, or even a law office." Corbin, *supra* note 5, at 772. *But see* Levi, *supra* note 12, at 523, ("Where legislative interpretation is concerned, therefore, it appears that legal reasoning does attempt to fix the meaning of the word. When this is done, subsequent cases must be decided upon the basis that the prior meaning remains."). Professor Levi did not say whether the maxim he asserted has a shelf life.

⁵⁷ For some thoughts about the First Congress's intent, see RITZ, *supra* note 24, at 11: "[T]he section's reference to 'the laws of the several states' probably was meant to say nothing more remarkable than that the national courts should use American law, and not British law. . . . [T]he second alternative is that Section 34 authorized the judiciary to use an American common law of crimes as an interim measure." What re-enacting Congresses might have intended is another

standing of contemporary American English usage, the idea of "laws" seems more concrete; that of "law" more abstract. A court might respond by excluding those legal conclusions that courts "find" from the meaning of "laws." I have responded by using the word "texts" in my definition. *Swift* itself and most, if not all, succeeding pre-*Erie* opinions, as well as *Erie* itself, turned on the definition of "laws" in "laws of the several states."⁵⁸ Often in silence and rarely, if ever, explicitly, they supposed or have been read to suppose the absence of a controlling federal constitutional, statutory, or treaty provision. Why the Justices deemed this key provision of section 1652 unworthy of explicit treatment, if only in a conclusory aside, I must leave to the legal historians. Perhaps we can never know how consciously the Justices looked, although there is some evidence that traces of the civil law tradition persisted, if not in the collective judicial consciousness, at least in the minds of certain Justices.⁵⁹

matter.

⁵⁸ Consider Justice Frankfurter's retrospective assessment:

In overruling *Swift v. Tyson* . . . , *Erie R. Co. v. Tompkins* did not merely overrule a venerable case. It overruled a particular way of looking at law which dominated the judicial process long after its inadequacies had been laid bare. Law was conceived as a "brooding omnipresence" of Reason, of which decisions were merely evidence and not themselves the controlling formulations. . . . [Swift doctrine] was so strongly rooted in the prevailing views concerning the nature of law, that the federal courts almost imperceptibly were led to mutilating construction even of the explicit command given to them by Congress to apply State law in cases purporting to enforce the law of a State. . . . *Swift v. Tyson* . . . did not enunciate novel doctrine. . . . It summed up prior attitudes and expressions in cases that had come before this Court and lower federal courts for at least thirty years, at law as well as in equity. . . . [T]he doctrine was congenial to the jurisprudential climate of the time.

Guaranty Trust Co. v. York, 326 U.S. 99, 101-03 (1945) (citations omitted).

⁵⁹ See, e.g., *Shelby v. Guy*, 24 U.S. (11 Wheat.) 361, 366 (1826) (finding a proposed application was "within the equity, if not within the actual meaning" of the statute). Read this way of speaking along with William N. Eskridge, Jr., *Public Values in Statutory Interpretation*, 137 U. PA. L. REV. 1007, 1012 (1989) (citations omitted):

Although similar in many respects to Anglo-American statutory inter-

The previous paragraph addresses the meaning of "laws" in the formulation "laws of the several states." What about the meaning of "several"? Webster's says, as its first meaning, "separate or distinct from one another," giving as a use in context, "federal union of the [several] states."⁶⁰ Random House says, as its second meaning, "respective; individual."⁶¹ Although "the laws of the several states" does not have a 20th-century ring to it,⁶² "several" here may acknowledge that "laws of the states" do not comprise a single body of law, but as many bodies as there are states.

e. "Rules of Decision"

I define "rules of decision" to mean *those texts controlling or informing a court's response to any question presented by the commencement or in the course of an action and bearing upon*

pretation, civil law interpretation is different in its more systematic tendency to seek coherence across statutes. Civil law judges derive principles from one statute and use those principles to make sense of the statute as a whole (the "equity of the statute") and to relate the statute to other statutes.

Compare the above passage with Shael Herman's reasoning:

[C]ivil code readers . . . are true believers in the "equity of the statute," an English phrase that corresponds to a civilian's description of legislation as *ratio scripta*. . . .

Although a search for the statute's "equity" has become indispensable for civil code readers, English judicial method has traditionally discouraged the technique, at least in the reading of statutes.

Shael Herman, *The "Equity of the Statute" and Ratio Scripta: Legislative Interpretation Among Legislative Agnostics and True Believers*, 69 TUL. L. REV. 535, 537-38 (1994). As one writer has cautioned, however, the US-American understanding of "equity of the statute" and "its civil law counterpart potentially represent a pair of false similarities." Andrew N. Adler, *Translating & Interpreting Foreign Statutes*, 19 MICH. J. INT'L L. 37, 73 (1997). Thus, only with careful reservations can we read much into Justice Johnson's reference to "the equity . . . of the statute" in *Shelby v. Guy*. But see *infra* note 437 and accompanying text.

⁶⁰ MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY, *supra* note 35, at 1073.

⁶¹ THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1754 (2d ed. unabridged 1987). Its first meaning reads, "being more than two but fewer than many in number or kind," which seems inapt. *Id.*

⁶² For some impressive sleuthing about its late 18th-century ring, see RITZ, *supra* note 24, at 83-87, 140-41.

the acceptance, conduct, or merits of the action. The formula, "[t]exts . . . bearing upon the conduct . . . of the action," corresponds roughly to the popular conception, "procedural law." The formula, "[t]exts . . . bearing upon the . . . merits of the action," corresponds roughly to the popular conception, "substantive law." In so defining "rules of decision," I leave out of mind for the time being the likelihood that the First Congress understood "rules of procedure" to fall outside the meaning of "rules of decision."⁶³ I also depart from Professor Ely's scheme⁶⁴ by applying section 2072 *through* section 1652, rather than *around*

⁶³ See, e.g., Act of Sept. 29, 1789, 1 Stat. 93-94. This is the original Rules of Decision Act's contemporary predecessor of the Conformity Act. If the Congress had thought "rules of decision" to include procedural rules, what field of operation could it have seen for the Conformity Act? It might have seen it as a placeholder in § 34's excepting clause, a means of asserting its competence to legislate rules of conduct for the federal courts it had created without presently originating such rules. However, Crosskey stated:

This section [section 34 of the Judiciary Act of 1789, i.e., the Rules of Decision Act], standing by itself, might probably today be taken to comprehend matters of process, or procedure as well as substance, in the "trials" it covered. In 1789, however, the phrase, "rules of decision," was used, and understood, in contradistinction to "rules of procedure," or "process"; and the intended, purely substantive application of section 34 was, furthermore, made completely clear by "an Act to regulate Processes in the Courts of the United States," which the First Congress, five days later, adopted.

2 CROSSKEY, *supra* note 24, at 820. See *Massingull v. Downs*, 48 U.S. (7 How.) 760, 767 (1849) (remarking section 34 "has never been considered as an act to regulate process."); *McCracken v. Hayward*, 43 U.S. (2 How.) 608, 615 (1844) (holding federal courts must conform to state process changes entirely or not at all); *Bronson v. Kinzie*, 42 U.S. (1 How.) 311, 314-15 (holding same as *McCracken*); *Bank of the United States v. Halstead*, 23 U.S. (10 Wheat.) 51, 54 (1825) (holding section 34 "has no application to the practice of the [federal] courts"); *Wayman v. Southard*, 23 U.S. (10 Wheat.) 1, 8-9 (1825) (holding same as *Halstead*).

⁶⁴ See Ely, *supra* note 1, at 698:

[W]here there is no relevant Federal Rule of Civil Procedure or other Rule promulgated pursuant to the Enabling Act and the federal rule in issue is therefore wholly judge-made, whether state or federal law should be applied is controlled by the Rules of Decision Act, the statute construed in *Erie* and *York*. Where the matter in issue is covered by a Federal Rule, however, the Enabling Act—and not the Rules of Decision Act itself or the line of cases construing it—constitutes the relevant standard.

Id. (emphasis added).

it.

As an intransitive verb, "decide" means "to make a choice or judgment."⁶⁵ We make choices about means as certainly as we make choices about ends. The words "procedure" and "proceeding" imply a series of steps toward some end. There are procedures for building houses and doing engine tuneups as important for accomplishing those ends as are the sovereign's procedures for resolving disputes. In the vernacular understanding, *Do I change the sparkplugs or clean them?* invites a decision as surely as does *Do I instruct the jury on contributory negligence or on comparative negligence?* If I share this understanding, which I do, perhaps federal judges, acting in their private personae, might share it, too. If so, perhaps they might draw upon it legitimately when acting in their public personae as official interpreters of section 1652. That is, a federal judge might, so far as "plain meaning" goes, understand *Do I grant or deny this motion for an order compelling an answer to this interrogatory?* to invite a decision within the meaning of section 1652 as surely as does *Do I instruct the jury on contributory negligence or comparative negligence?*

Furthermore, it seems that federal judges would perceive a compelling reason in policy to understand "decision" in this inclusive way. To exclude rules of procedure from the scope of section 1652's rules of decision expands the unedifying influence of "[t]hose dread words 'substantive' and 'procedural.'"⁶⁶ It fosters, if indeed it does not compel, tripartite analyses such as Professor Ely's.⁶⁷ It exacerbates, if indeed it has not in-

⁶⁵ MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY, *supra* note 35, at 298.

⁶⁶ Ely, *supra* note 1, at 722. As one of many possible reasons to dread the words, see *Gasperini v. Center for Humanities, Inc.*, 518 U.S. 415, 426 (1996), in which the majority opinion characterized a certain state statutory provision as both substantive and procedural. See also Clark 2, *supra* note 5, at 420 ("Almost any rule having to do with the orderly dispatch of judicial procedure partakes of the nature of both substance and procedure.").

⁶⁷ Ely, *supra* note 1, at 697-98 (emphasis added):

[T]he indiscriminate admixture of all questions respecting choices between federal and state law in diversity cases, under the single rubric of "the Erie doctrine" or "the Erie problem," has served to make a major mystery out of what are really *three* distinct and rather ordinary prob-

duced, *Erie* doctrine's "split personality."⁶⁸ It exposes even rules of decision clearly *required* by federal constitutional provisions to the indignity and uncertainty of *Erie* balancing.⁶⁹ In sum, it seems politic as well as linguistically logical to define "decision" to include every choice between or among alternatives at any and all steps of a judicial proceeding.

So doing does not entrench section 1652 in the sense of putting it beyond the power of Congress to amend it by the usual majority, but it does superordinate it in the sense of putting it beyond amendment by implication. Doing that, however, takes nothing from the utility of a statute like section 2072, which stands at a different level of operation. So viewed, section 1652 simply absorbs section 2072 into its commodious definition of "rules of decision," thus spotlighting it and the rules promulgated under its authority as sources of federal law commanding federal judicial obedience. Put another way, section 1652 establishes the fundamental rule about choosing between federal and state law; section 2072 delegates certain authority to create rules of decision; rules promulgated under section 2072 directly *provide* or somewhat less directly *require* rules of decision; some federal statutes, perhaps most other federal statutes, also directly *provide* or somewhat less directly *require* rules of decision. I have found no, and can scarcely imagine any, other statute that stands at section 1652's commanding metastatutory level of organization with regard to choices of law by federal courts.⁷⁰

lems of statutory and constitutional interpretation.

Id. (emphasis added).

⁶⁸ Freer, *supra* note 5, at 1089 ("Part of *Erie*'s problem is that it was diagnosed as having a split personality in *Hanna v. Plumer*.").

⁶⁹ Are not the due process mandates of the Fifth and Fourteenth Amendments, if not their equal protection mandates, "procedural," procedural "having a substantive tinge," *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 561 (1949) (Rutledge, J., dissenting), or at least "rationally capable of classification as either [procedural or substantive]?" *Hanna v. Plumer*, 380 U.S. 460, 472 (1965).

⁷⁰ Recall how, in a case considering whether 42 U.S.C., § 1988 *required* a uniform federal rule concerning the survival of a civil rights action, Justice Blackmun, writing in dissent, characterized the Rules of Decision Act as "the

To those who choose to follow Professor Ely, who did, it seems, have conventional wisdom on his side, the *provide-or-require* mandate might still recommend itself, although with somewhat less to offer.

f. "Shall Be Regarded As"

The waffly formulation "shall be regarded as" seems something less than a mandate. According to *Webster's New Collegiate Dictionary*, *regard* means to *give attention* or *consider*,⁷¹ both of which fall short of *obey* or *be bound by*. Compare, for examples, "shall be applied," "regarded as binding rules of decision," or "shall provide rules of decision." Are there circumstances under which the laws of the several states can be *disregarded* as rules of decision? If "disregard" means *decline to follow*, yes, where federally enacted law so *provides* or *requires*, state law may be disregarded.⁷² If "disregard" means *leave out of mind when identifying and interpreting possibly controlling federally enacted texts*, then state law must not be disregarded.

other major choice-of-law provision in the federal structure." Robertson v. Wegmann, 436 U.S. 584, 597 (1977) (Blackmun, Brennan, and White, JJ., dissenting). He continued:

Just as the Rules of Decision cases disregard state law where there is conflict with federal *policy*, even though no explicit conflict with the terms of a federal statute, so, too, state remedial and procedural law must be disregarded under [42 U.S.C.] § 1988 where that law fails to give adequate expression to important federal concerns.

Id. at 598 (Blackmun, J., dissenting). The majority, however, held that § 1988 did not *require* a uniform rule of decision favoring the survival of a civil rights action, saying, nevertheless, "[w]e intimate no view, moreover, about whether abatement based on state law could be allowed in a situation in which deprivation of federal rights caused death." *Id.* at 594.

⁷¹ MERRIAM WEBSTER'S COLLEGIATE DICTIONARY at 984 (10th ed. 1993).

⁷² Although a court might hold them in mind while deciding whether a federal statutory source so provided passed constitutional muster or whether a federal source should be read to so *require*. See *infra* note 631 and accompanying text.

g. "Courts of the United States"

I take "courts of the United States" to mean "[the] Supreme Court and . . . such inferior Courts as the Congress may from time to time ordain and establish,]"⁷³ drawing upon our contemporary colloquial distinction between "federal courts" and "state courts." Although one falls easily into the supposition that section 1652 provides direction only for cases or controversies *commenced* in courts of the United States, nothing in the section's language suggests that limitation. Reading it without that limitation brings cases like *Hinderlider*,⁷⁴ as well as cases like *Erie*, within the scope of this inquiry.

In a sense sometimes heard in halls and classrooms, of course, state courts are also "courts of the United States." Although the thought merits more mature consideration, it seems section 1652 would produce rational and unexceptional results if read to provide direction for cases and controversies maintained in "state courts" as well. That expansive reading would effectively implement the Supremacy Clause, making section 1652 an instrument of sweeping utility. I leave to subsequent inquiry the status of specialized tribunals.

h. "In Cases Where They Apply"

What shall be done with the phrase, "in cases where they apply"? It suggests that the class of cases to which the laws of the several states apply as rules of decision is or may be smaller than the class of cases remaining after subtracting the class of cases to which federally enacted texts apply from all the cases maintained in federal courts. This interpretation, however, suggests a class of cases controlled by neither established federal nor established state law, a conclusion making no readily apparent sense. It is, some might say, a mistake into which *Swift v. Tyson*⁷⁵ led us. What else might the phrase mean? To

⁷³ U.S. CONST. art. III, § 1.

⁷⁴ *Hinderlider v. LaPlata River Ditch Co.*, 304 U.S. 92, 110 (1938) (applying federal common law to action commenced in state court). See text at p. 98 and nn.454-55 *infra*.

⁷⁵ 41 U.S. (16 Pet.) 1 (1842).

me, it makes some sense if regarded as a last-phrase attempt to tighten up the meaning of the seemingly careless and undirected "laws of the several states" with which the statute began.⁷⁶ That is, the laws of all of the states do not, willy-nilly, provide rules of decision for a particular court of the United States entertaining a particular civil action. The laws of Massachusetts, for example, provide a rule of decision in a civil action in a court of the United States sitting in Massachusetts, if a court of the state of Massachusetts would draw its rule of decision from the laws of Massachusetts. The laws of Massachusetts do not provide a rule of decision in a civil action in a court of the United States sitting in Virginia, unless a court of the state of Virginia would draw its rule of decision from the laws of Massachusetts.⁷⁷ That is, texts from the laws of different states may compete for recognition as the rule of decision. Likewise, texts from the laws of the same state may compete for recognition. Consider, for example, the line of pre-*Erie* cases in which the Justices declined to apply state law that would impair the obligation of contracts created before the rejected law's promulgation.⁷⁸ Whether the competition among state "laws" is interstate or intrastate, the phrase "in cases where they apply" may tell us to apply some auxiliary choice of law rule, find it where we may.⁷⁹ My reading of "laws of the several states . . . in cases where they apply" permits, or perhaps requires, omitting the words "several states" from my proposed restatement of section 1652.

II. THE EXPERIMENT

How well does this proposed understanding of section 1652, with its front-and-center reliance on a back-to-the-statute *provide-or-require* mandate, rationalize the welter of judicial

⁷⁶ But see RITZ, *supra* note 24, at 83-87, 140-41.

⁷⁷ Does this anticipate *Klaxon v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941), in a way that violates the rules of engagement? See *supra* pp. 172-74.

⁷⁸ See *infra* pp. 197, 202 at n.111, 217-28.

⁷⁹ Speaking in historical context, however, see RITZ, *supra* note 24, at 140-41, 146. But cf. BRIDWELL & WHITTEN, *supra* note 24, at 81, 95, 110-11, 130, 135.

decisions from 1789 to the present?

Sampling problems loom large from the start. To exhaust the body of judicial decisions that either did cite or should have cited the Rules of Decision Act under any of its aliases would require a virtually clause-by-clause treatise upon both the United States Constitution and the United States Code, to say nothing of the Federal Rules of Civil Procedure, the Federal Rules of Evidence, and large bodies of federal regulations. For the purposes of this first study, I have sampled by shopping in the text and footnotes of my predecessors' works. Beginning with *Swift* and *Erie* and the scholars who have written about *Swift* and *Erie*, I have gone next to the cases cited there. From there, I have gone on to cases cited in that original sample of cases and to cases cited in cases cited in the original sample. I have also carried out numerous computerized searches, some more successful than others. With perhaps one or two exceptions, I have limited myself to decisions issued in the name of the United States Supreme Court.

How well does a back-to-the-statute *provide-or-require* calculus explain decisions before *Swift*? *Swift* itself? Decisions between *Swift* and *Erie*? *Erie* itself? Decisions since *Erie*? As applied to the sample tested, very well indeed. Does an understanding that seemingly explains everything with such facility explain anything at all? Perhaps it is so implicit in the corpus juris that bothering to say so approaches transcendent triviality. Still, recall the old story about the New England farmer who told the hopelessly lost New York vacationer, "You can't get there from here."⁸⁰ Perhaps it is at least true, when lost on the backroads of ideas, that we may reach our destinations more easily from some starting points than from others.⁸¹ If *implicit* means *not recognized as a starting point* and *explicit*

⁸⁰ MIKE DODGE & BOB BRYAN, *Which Way to Millinocket?* in "BERT AND I"—AND OTHER STORIES FROM DOWN EAST (Bert & I, Inc., 1961). Thanks for the citation to the source go to my colleague, Professor Timothy J. Hoff.

⁸¹ In somewhat the same vein, recall Justice Jackson's concurrence in *First Nat'l Bank, Ex'r v. United Airlines, Inc.* ("[S]ometimes the path that we are beating out by our travel is more important to the future wayfarer than the place in which we choose to lodge."). 342 U.S. 396, 398 (1952) (Jackson, J., concurring).

means otherwise, then perhaps explicating the implicit has value even beyond the fun of doing it.

A. Cases Before Erie

1. Swift and pre-Swift: *The Received Wisdom*

In *Swift v. Tyson*, Justice Story said:

In the ordinary use of language it will hardly be contended that the decisions of Courts constitute laws. . . . The laws of a state are more usually understood to mean the rules and enactments promulgated by the legislative authority thereof, or long established local customs having the force of laws.⁸²

This beginning itself bears a suggestive resemblance to Roman understandings of law and laws, reminding us of Justice Story's familiarity with civil law understandings. He continued:

In all the various cases, which have hitherto come before us for decision, this Court [has] uniformly supposed, that the true interpretation of the 34th section limited its application to state laws strictly local, that is to say, to the positive statutes of the state, and the construction thereof adopted by the local tribunals, and to rights and titles to things having a permanent locality, such as the rights and titles to real estate, and other matters immovable and intraterritorial in their nature and character.⁸³

Justice Story concluded, "[W]e have not now the slightest difficulty in holding, that this section, upon its true intendment and construction, is strictly limited to local statutes and local usages of the character before stated, and does not extend to contracts and other instruments of a commercial nature"⁸⁴ If we can believe Justice Frankfurter's retrospective assessment, "*Swift v. Tyson* . . . did not enunciate novel doctrine. . . . It summed up prior attitudes and expressions in cases that had come before this Court and lower federal courts

⁸² 41 U.S. (16 Pet.) at 18 (emphasis added).

⁸³ *Id.* at 18.

⁸⁴ *Id.* at 19.

for at least thirty years, at law as well as in equity. . . . [T]he doctrine was congenial to the jurisprudential climate of the time.⁸⁵ The cases do more or less support Justice Story's canonical generalizations.

Justice Story's restatement of pre-*Swift* case law was both underinclusive and overinclusive. It did not include state constitutions, although the Supreme Court had, at least once, given regard to a state constitutional provision before *Swift*.⁸⁶ On its face, it included all state statutes "strictly local," although it should not have.⁸⁷ It properly included *rules of local property*,⁸⁸ but only by a stretch did it include other *local rules of property*, although it might have done so definitively.⁸⁹ His

⁸⁵ *Guaranty Trust Co. v. York*, 326 U.S. 99, 102-03 (1945).

⁸⁶ *See Groves v. Slaughter*, 40 U.S. (15 Pet.) 449, 497 (1841) (discussing Mississippi constitutional provision affecting slaves as property).

⁸⁷ *See, e.g., Boyle v. Zacharie*, 31 U.S. (6 Pet.) 635, 658 (1832) (holding that Maryland statutes regulating proceedings on injunctions and other matters in chancery did not control equity proceedings in the United States Circuit Court for the District of Maryland); *United States v. Howland*, 17 U.S. (4 Wheat.) 108, 115 (1819) (holding that Massachusetts statute making plaintiff's remedy at law adequate in Massachusetts state court did not make plaintiff's remedy at law adequate in the United States Circuit Court for the District of Massachusetts). By the understanding of the time, Justice Story may not have had to make this explicit. *See, e.g., Act of Sept. 29, 1789*, 1 Stat. 93-94; *Wayman v. Southard*, 23 U.S. (10 Wheat.) 1, 21-22 (1825) (stating that Congress has power to regulate proceedings in federal courts through the Constitution).

⁸⁸ *See Elmendorf v. Taylor*, 23 U.S. (10 Wheat.) 152, 165 (1825); *Polk's Lessee v. Wendell*, 18 U.S. (5 Wheat.) 293, 302 (1820); *Shipp v. Miller's Heirs*, 15 U.S. (2 Wheat.) 316, 325 (1817); *Patton's Lessee v. Easton*, 14 U.S. (1 Wheat.) 476, 479 (1816); *Matson v. Hord*, 14 U.S. (1 Wheat.) 130, 132 (1816); *Polk's Lessee v. Wendal*, 13 U.S. (9 Cranch) 87, 98 (1815); *McKeen v. Delancy's Lessee*, 9 U.S. (5 Cranch) 22, 32 (1809); *Huidekoper's Lessee v. Douglass*, 7 U.S. (3 Cranch) 1, 70-71 (1805); *Wilson v. Mason*, 5 U.S. (1 Cranch) 45, 94-95 (1801); *Sims' Lessee v. Irvine*, 3 U.S. (3 Dall.) 425, 457 (1799).

⁸⁹ *See, e.g., Groves v. Slaughter*, 40 U.S. (15 Pet.) 449, 497 (1841) (regarding Mississippi constitutional provision affecting property in slaves); *Wheaton v. Peters*, 33 U.S. (8 Pet.) 591, 658 (1834) (citing Pennsylvania's common law of copyright; but overridden by federal copyright statute); *Gardner v. Collins*, 27 U.S. (2 Pet.) 58, 92-93 (1829) (implicating Rhode Island statute of descents); *Jackson v. Chew*, 25 U.S. (12 Wheat.) 153, 167 (1827) (wills; New York case law; deference extends beyond "state constructions of their own statutes"); *Daly's Lessee v. James*, 21 U.S. (8 Wheat.) 495, 535 (1823) (wills; pertaining to application of Pennsylvania case law).

restatement also included deeply overlapping categories. His category for "rights and titles to [local] things" overlapped extensively his category for "local statutes."⁹⁰ Indeed, only a few cases turning upon a local rule of property did not also turn upon a state statute.⁹¹ Finally, his restatement did not disregard state case law as extensively as successor courts supposed, although it may have disregarded state-enacted texts more extensively than supposed. Though he began by denying broadly "that the decisions of courts constitute laws," he subsequently narrowed this assertion in two ways. First, he acknowledged regard for "the construction [of positive statutes] adopted by the local tribunals." Second, he narrowed its scope to the exigencies of the case before him, saying, "[T]his section [the Rules of Decision Act] . . . does not extend to contracts and other instruments of a commercial nature," with "commercial nature" apparently modifying both "contracts" and "other instruments." He did not, however, expressly limit this assertion to state court decisions concerning contracts and other instruments of a commercial nature. Thus, as the later decision in *Watson v. Tarpley*⁹² implies, he and other members of the Court might have thought it extended as well to *state constitutional and statutory provisions* concerning contracts and other instruments of a commercial nature.

⁹⁰ See, e.g., *Elmendorf v. Taylor*, 23 U.S. (10 Wheat.) 152, 535 (1825) (Kentucky statute); *Polk's Lessee v. Wendell*, 18 U.S. (5 Wheat.) 293, 302 (1820) (Tennessee and North Carolina statutes); *Shipp v. Miller's Heirs*, 15 U.S. (2 Wheat.) 316, 325 (1817) (Kentucky statute); *Patton's Lessee v. Easton*, 14 U.S. (1 Wheat.) 476, 479 (1816) (Tennessee statute); *Matson v. Hord*, 14 U.S. (1 Wheat.) 130, 132 (1816) (Kentucky statute); *Polk's Lessee v. Wendal*, 13 U.S. (9 Cranch) 87, 98 (1815) (Tennessee statute); *McKeen v. Delancy's Lessee*, 9 U.S. (5 Cranch) 22, 32 (1809) (Pennsylvania statute); *Huidekoper's Lessee v. Douglass*, 7 U.S. (3 Cranch) 1, 70-71 (1805) (Pennsylvania statute); *Wilson v. Mason*, 5 U.S. (1 Cranch) 45, 94-95 (1801) (Virginia statute); *Sims' Lessee v. Irvine*, 3 U.S. (3 Dall.) 425, 457 (1799) (Pennsylvania law alluded to was probably statutory).

⁹¹ See, e.g., *Jackson v. Chew*, 25 U.S. (12 Wheat.) 153, 167 (1827) (wills; New York case law; deference extends beyond "state constructions of their own statutes"); *Daly's Lessee v. James*, 21 U.S. (8 Wheat.) 495, 511-12 (1823) (wills; regarding application of Pennsylvania case law).

⁹² 59 U.S. (18 How.) 517, 519-20 (1855). See *infra* pp. 229-32; see also *Carpenter v. Providence Washington Ins. Co.*, 41 U.S. (16 Pet.) 495, 511-12 (1842).

The mix of cases presenting issues about competing state and federal rules of decision changed over time. The rush to the first frontier generated the "landgrab" cases that dominated the United States Supreme Court's pre-*Swift* choice-of-law agenda. Aided by advancing technology, successive frontiers gave way to settlement. As that happened, and perhaps as land title litigants learned they gained no advantageous choice of law by resorting to federal court, the "landgrab" cases gradually gave way after *Swift* to cases about railroad bonds and railroad injuries. The legal community's and the Supreme Court's perceptions of *Swift*'s import changed with the changing times. That is to say, on the eve of *Erie Railroad Company v. Tompkins*,⁹³ the general understanding about what the Rules of Decision Act meant and did not mean by "laws of the several states" had evolved to encompass the ground charted in the next several paragraphs.

The meaning of "laws" included provisions of the forum state's constitution and statutes establishing or regulating local rules of property. In the many cases sampled, the Supreme Court behaved according to the canonical generalization, applying a rule of decision provided or required by a provision of the forum state's constitution or statutes. In some of these cases, the Justices applied or apparently applied the forum state high court's⁹⁴ settled or most recent interpretation of the provision.⁹⁵ In others, they did not. In those cases in which they did not, they sometimes appeared to apply their own interpreta-

⁹³ 304 U.S. 64 (1938). See *infra* pp. 245-48.

⁹⁴ I adopt "high court" as a convenient cover term to control for and postpone questions about the sources of state law available to federal courts which seek controlling state rules of decision. As one example of the later literature regarding this subinquiry, see Kurland, *supra* note 5, at 204-18.

⁹⁵ See *Fairfield v. County of Gallatin*, 100 U.S. 47, 50-51 (1879); *Township of Elmwood v. Marcy*, 92 U.S. 289 (1875); *Leffingwell v. Warren*, 67 U.S. (2 Black) 599 (1862); *Webster v. Cooper*, 55 U.S. (14 How.) 488, 502-04 (1852); *Van Rensselaer v. Kearney*, 52 U.S. (11 How.) 297, 318 (1850); *Nesmith v. Sheldon*, 48 U.S. (7 How.) 812, 818 (1849); *Green v. Neal's Lessee*, 31 U.S. (6 Pet.) 291, 294-98 (1832); *Shipp v. Miller's Heirs*, 15 U.S. (2 Wheat.) 316, 325 (1817); *Patton's Lessee v. Easton*, 14 U.S. (1 Wheat.) 476, 479 (1816); *Matson v. Hord*, 14 U.S. (1 Wheat.) 130, 132 (1816); *Polk's Lessee v. Wendal*, 13 U.S. (9 Cranch) 87, 98 (1815); *McKeen v. Delancy's Lessee*, 9 U.S. (5 Cranch) 22, 32 (1809).

tions of the provisions, either because they found no forum state court interpretation at all,⁹⁶ or because they found no forum state court interpretation published before the date of the contractual or proprietary transaction at bar.⁹⁷

As to the first subclass identified in the previous paragraph, the Justices might have thought themselves constrained to choose the interpretation the state's high court would have chosen, rather than free to choose for themselves. Their decisions will support this view; the language of their opinions sometimes will not or at least arguably will not.⁹⁸ To the ex-

⁹⁶ See *Town of Concord v. Portsmouth Sav. Bank*, 92 U.S. 625, 630-31 (1875); *Railroad Co. v. County of Otoe*, 83 U.S. (16 Wall.) 667, 674-75 (1872); *Groves v. Slaughter*, 40 U.S. (15 Pet.) 449, 497 (1841); *Gardner v. Collins*, 27 U.S. (2 Pet.) 58, 92-93 (1829); *Huidekoper's Lessee v. Douglass*, 7 U.S. (3 Cranch) 1, 70-71 (1805); *Wilson v. Mason*, 5 U.S. (1 Cranch) 45, 94-95 (1801).

But see *Murray's Lessee v. Baker*, 16 U.S. (3 Wheat.) 541 (1818). Murray brought his action in ejectment against Baker in the United States Circuit Court for the District of Georgia. *Id.* at 545. Baker set up the Georgia statute of limitation, asserting that Murray had not been "beyond seas," as provided by the statute, but merely "without the limits of the state." *Id.* Without, for aught that appears, looking for a Georgia interpretation and without citing the Rules of Decision Act, the Supreme Court held, as "a sensible construction," "beyond seas" equivalent to "without the limits of the state." *Id.*

⁹⁷ See *County of Otoe v. Baldwin*, 111 U.S. 1, 16 (1884); *Burgess v. Seligman*, 107 U.S. 20 (1883); *Butz v. City of Muscatine*, 75 U.S. (8 Wall.) 575, 582-83 (1869); *Rowan v. Runnels*, 46 U.S. (5 How.) 134 (1847); *Shelby v. Guy*, 24 U.S. (11 Wheat.) 361, 366-67 (1826).

⁹⁸ See, e.g., *Railroad Co. v. County of Otoe*, 83 U.S. (16 Wall.) 667 (1872), which was an action brought in the United States Circuit Court for Nebraska by the railroad company, as holder of railroad bonds, to recover against the issuer. Otoe County contended that the statute authorizing issuance of the bonds was void under Nebraska's state constitution. *Id.* at 672. The Nebraska Supreme Court had not yet addressed the question. *Id.* at 674. The circuit court certified the question. *Id.* at 677. The United States Supreme Court held the statute valid under Nebraska's constitution. *Id.* Justice Strong said:

Unless we close our eyes to what has again and again been decided by this court, and by the highest courts of most of the States, it would be difficult to discover any sufficient reason for holding that this act was transgressive of the power vested by the constitution of the State in the legislature.

Id. at 672. The majority did not say whether it so ruled, because it thought the Nebraska Supreme Court would have decided that way, or because it thought its decision best notwithstanding a possibly contrary view by the Nebraska Supreme Court. Readers who choose the latter conclusion will agree that this case is proper-

tent the Supreme Court actually so constrained itself, these decisions are consistent with the canonical generalization. To the extent it did not so constrain itself, the decisions can be harmonized with the canonical generalization only by reading the absence of a "settled" state court interpretation as a license to rule, rather than a mandate to divine.

As to the second subclass, the Supreme Court thought its decisions required by a rule against impairing the obligation of contracts. Most often, it neglected to say whether it drew this rule from state or federal law. In one instance, at least, it invoked federal law explicitly.⁹⁹ To the extent the Court drew its rule against impairing the obligation of contracts from the law of the forum state, either actual or predicted, these decisions are consistent with the canonical generalization. To the extent it drew this rule from federal law, the decisions square more readily with *provide-or-require* reasoning than with reliance upon the resolving power of *Swift's* definition of "laws."

The Supreme Court did not always apply its own interpretation of a state constitutional or statutory provision whenever it declined to apply the forum state high court's settled or most recent interpretation of the provision. Sometimes it applied a forum state court interpretation other than the most recent.¹⁰⁰ When it did so, the Court thought its decisions required by a rule against impairing the obligation of contracts, just as it did in that subclass of cases in which it chose an earlier federal interpretation. Just as in those cases, the Court seldom said whether it drew this rule from state or federal law. Once again, to the extent it drew this rule from the law of the forum state, either actual or predicted, these decisions square with the canonical generalization. And to the extent they drew this rule from federal law, the decisions square more readily

ly cited here.

⁹⁹ See *Township of Pine Grove v. Talcott*, 86 U.S. (19 Wall.) 666, 678 (1873).

¹⁰⁰ See *id.* at 767-77; *Olcott v. Supervisors*, 83 U.S. (16 Wall.) 678 (1872); *City of Kenosha v. Lamson*, 76 U.S. (9 Wall.) 477, 485-86 (1869); *Thomson v. Lee County*, 70 U.S. (3 Wall.) 327, 330-31 (1865); *Gelpcke v. City of Dubuque*, 68 U.S. (1 Wall.) 175, 205-06 (1863); *Morgan v. Curtenius*, 61 U.S. (20 How.) 1, 3 (1857); *Pease v. Peck*, 59 U.S. (18 How.) 595, 598-99 (1855).

with *provide-or-require* reasoning than with reliance upon the resolving power of *Swift's* definition of "laws."

The meaning of "laws" included forum state court decisions reflecting law and custom regarding "strictly local" matters not encompassed by state statutes. In cases wherein case law conveyed the forum state's rule of decision deemed "local," for example, the law of wills,¹⁰¹ the Court deferred to settled decisions of the forum state's highest court.

The meaning of "laws" did not include state judicial interpretations of common law rules.¹⁰² It did, however, at least according to one view, include a state's decision to apply a common law rule.¹⁰³ The Supreme Court applied a common law rule of decision according to its own understanding, regarding forum state decisions only as persuasive authority on a par with decisions from any other jurisdiction.

From time to time, the Court also rendered decisions not fitting comfortably in any of the canonical generalization's categories. Thus, it occasionally had to draw the line, never articulately, between *res judicata* and *stare decisis*.¹⁰⁴ And, at least once, the Court had to address a forum state court's interpretation of a federal constitutional provision's affect on state law.¹⁰⁵ Discussions of the canonical generalization usually, if indeed not always, cite these cases indiscriminately with the

¹⁰¹ See *Jackson v. Chew*, 25 U.S. (12 Wheat.) 153, 167 (1827) (regarding application of New York case law; deference extends beyond "state constructions of their own statutes"); *Daly's Lessee v. James*, 21 U.S. (8 Wheat.) 495, 535 (1823) (regarding application of Pennsylvania case law).

¹⁰² For a glimpse of the history which I presently deny myself, see RITZ, *supra* note 24, at 51 ("[N]o state court in 1789 could have declared what the law of that state was. There was in fact no such authoritative source for the law of a state. Consequently, Congress could not have required the national courts to look to the opinions of state courts to ascertain what state law was; this would have been unthinkable.").

¹⁰³ See TEPLEY & WHITTEN, *supra* note 7, at 380-81; BRIDWELL & WHITTEN, *supra* note 24, at 61-97.

¹⁰⁴ See *Carroll County v. Smith*, 111 U.S. 556, 562-63 (1884); *Foxcroft v. Mallett*, 45 U.S. (4 How.) 353, 379 (1846); *Lane v. Vick*, 44 U.S. (3 How.) 464, 476-77 (1845). For a post-*Erie* decision of the same kind, see *Wichita Royalty Co. v. City Bank*, 306 U.S. 103, 106-07 (1938).

¹⁰⁵ See *Boyce v. Tabb*, 85 U.S. (18 Wall.) 546, 548 (1873).

rest.

So that's what was; or, at least, what seems to have been, taking the holdings and opinions at face value.¹⁰⁶ For aught that usually appeared in the opinions, provisions of forum state constitutions and statutes, along with their settled interpretations, controlled, not because no provision of federal law *provided* or *required* otherwise, but because they passed muster as "laws of the several states." Decisions by a forum state's high court concerning "local" matters controlled not because no federal law *provided* or *required* otherwise, but because they passed muster as "laws of the several states." Decisions by a forum state's high court concerning questions governed by common law rules failed to control, not because federal law *provided* or *required* otherwise, but because they did *not* pass muster as "laws of the several states." The Supreme Court rarely, if indeed ever, ventured definitions of terms other than "laws of the several states," or even acknowledged that other terms might bear upon the statute's application.

2. *Intimations of a Different Order*

But I have weaseled, at least a little. I have spoken only of what opinions "usually" said, not what seemed to move just behind the screen of the professed *ratio decidendi*, and not what opinion writers occasionally let slip.

First, a federal interest rooted in a constitutional provision is seldom hard to find. Many decisions in the sample affected the interests of interstate creditors, suggesting, even when the Court did not, the federal interest in interstate commerce.¹⁰⁷

¹⁰⁶ As a "presentist" would perceive face value? See RITZ, *supra* note 24, at 159 ("the kind of presentism widely prevalent today, viewing [the past] as if it were a mirror image of [the present].").

¹⁰⁷ *Swift* itself was such a case. See *County of Otoe v. Baldwin*, 111 U.S. 1 (1884); *Burgess v. Seligman*, 107 U.S. 20 (1883); *Township of Elmwood v. Marcy*, 92 U.S. 289 (1875); *Township of Pine Grove v. Talcott*, 86 U.S. (19 Wall.) 666 (1873); *Olcott v. Supervisors*, 83 U.S. (16 Wall.) 678 (1872); *Railroad Co. v. County of Otoe*, 83 U.S. (16 Wall.) 667 (1872); *City of Kenosha v. Lamson*, 76 U.S. (9 Wall.) 477 (1869); *Butz v. City of Muscatine*, 75 U.S. (8 Wall.) 575 (1869); *Thomson v. Lee County*, 70 U.S. (3 Wall.) 327 (1865); *Gelpcke v. City of*

Many of the decisions, indeed some of the same decisions, affected the interests of interstate railroads,¹⁰⁸ again suggesting the federal interest in interstate commerce, embodied from the beginning in the Constitution and soon thereafter by acts of Congress.¹⁰⁹

Then, too, opinions now and then hinted about what might have been. Occasionally, the Court invoked the diversity jurisdiction statute, implying *sub silentio*, though seldom, if ever, saying outright, that the statute and the constitutional language and policy it implemented *required* it to eschew state law inconsistent with federal policy.¹¹⁰ At times, its opinions asserted a rule against impairments of the obligation of contracts. Although the Court often did not say whether it found the rule

Dubuque, 68 U.S. (1 Wall.) 175 (1863); *Pease v. Peck*, 59 U.S. (18 How.) 595 (1855); *Watson v. Tarpley*, 59 U.S. (18 How.) 517 (1855); *Nesmith v. Sheldon*, 48 U.S. 812 (1849); *Rowan v. Runnels*, 46 U.S. (5 How.) 134 (1847).

¹⁰⁸ See *Black & White Taxicab & Transfer Co. v. Brown & Yellow Taxicab & Transfer Co.*, 276 U.S. 518 (1928); *Beutler v. Grand Trunk Junction Railway*, 224 U.S. 85 (1912); *Baltimore & Ohio R.R. Co. v. Baugh*, 149 U.S. 368 (1893); *County of Otoe v. Baldwin*, 111 U.S. 1 (1884); *Burgess v. Seligman*, 107 U.S. 20 (1883); *Township of Elmwood v. Marcy*, 92 U.S. 289 (1875); *Township of Pine Grove v. Talcott*, 86 U.S. (19 Wall.) 666 (1873); *Railroad Co. v. Lockwood*, 84 U.S. (17 Wall.) 357 (1873); *Olcott v. Supervisors*, 83 U.S. (16 Wall.) 678 (1872); *Railroad Co. v. County of Otoe*, 83 U.S. (16 Wall.) 667 (1872); *City of Kenosha v. Lamson*, 76 U.S. (9 Wall.) 477 (1869); *Thomson v. Lee County*, 70 U.S. (3 Wall.) 327 (1865); *Gelpcke v. City of Dubuque*, 68 U.S. (1 Wall.) 175 (1863).

¹⁰⁹ For an introduction to this subinquiry, see JOSEPH E. KALLENBACH, *FEDERAL COOPERATION WITH THE STATES UNDER THE COMMERCE CLAUSE* (1968); FELIX FRANKFURTER, *THE COMMERCE CLAUSE UNDER MARSHALL, TANEY, AND WAITE* (1937).

¹¹⁰ *But see* *Suydam v. Williamson*, 65 U.S. (24 How.) 427, 433 (1861) ("The power to establish federal courts, and to endow them with a jurisdiction to determine controversies between certain parties, affords no pretext for abrogating any established law of property. . . ."). This, however, can be read as leavening the federal constitutional oversight of interstate commerce with a federal constitutional proscription of the disappointment of vested expectations, rather than with any special concern for the balance between state and federal authority. Compare BRIDWELL & WHITTEN, *supra* note 24, at 66-67, 70, 73, 75, 77-78, 89, 91 ("Blind adherence to state decisions declaring the general customs of the commercial world would have been a violation of the separation of powers doctrine, because it would have constituted a disregard of the general congressional command embodied in the diversity jurisdiction to do justice between citizens of different states."), 92, 95, 107, 116, 131 (emphasis added).

against such impairments in the "laws of the several states" or "require[d] or provide[d]" by federal law, once in a while it invoked federal law. In *Township of Pine Grove v. Talcott*, for example, Justice Swayne said: "The National Constitution forbids the States to pass laws impairing the obligation of contracts."¹¹¹ Language like this does not square easily with the traditional *Swift-Erie* view of federal-state "choices"¹¹² of law; it fits more comfortably with a *provide-or-require* calculus.

3. The Provide-or-Require Calculus

Building upon the overview suggested in the preceding two paragraphs, let us consider now in some detail whether and how the Justices might have defended their decisions, had they consciously applied back-to-the-statute *provide-or-require* reasoning. In thinking about what the Justices might have done, the terms of the experiment require us to suppose idealized persons purged of all the intellectual and political biases of the times through which they passed. Let us put off for the time being our understanding that, according to the received wisdom,¹¹³ they did not understand themselves to be reasoning in this manner. We must ask only whether, in our laboratory of thought experiments, they might have so reasoned. Let us ignore also the precedents and literature vexing the question whether Article I established mandates directly requiring federal judicial behavior and, if so, what behavior,¹¹⁴ asking only whether the Justices might, by civilian¹¹⁵ lights, legitimately

¹¹¹ 86 U.S. (19 Wall.) 666, 678 (1873).

¹¹² When federal law is on point, the Supremacy Clause makes the idea of choice between federal and state law illusory.

¹¹³ See, e.g., RITZ, *supra* note 24; FREYER, *supra* note 24; BRIDWELL & WHITTEN, *supra* note 24; 2 CROSSKEY, *supra* note 24.

¹¹⁴ For an introduction to at least a part of this subinquiry, see 2 RONALD D. ROTUNDA & JOHN E. NOWAK, *TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE* §§ 11.1, 12.6(b) (2d ed. 1992); LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 401-41 (2d ed. 1988); Hill, *supra* note 5, at 442 ("Thus the commerce clause is self-executing insofar as, without Congressional implementation, it is deemed to prevent the states from interfering with the flow of interstate and foreign commerce.").

¹¹⁵ Applying "the equity of the code." See *supra* note 59 and accompanying

have included attention to Article I in determining whether the Constitution *required* a certain rule of decision.

Had the Court charted its course by the statute's *provide-or-require* mandate, rather than by a definition of "laws of the several states," could its decision in *Swift* itself, its decisions in pre-*Swift* cases, and its decisions in most of the post-*Swift*, pre-*Erie* cases have come out the same way? Once again, you will decide for yourself where this inquiry leads you. In the remainder of this study, I can only report where it has led me.

*a. Swift v. Tyson*¹¹⁶

Beginning his analysis with the "require or provide" clause of section 34, Justice Story could have justified his desired result. So far as research has revealed, he would have found in the United States Constitution, acts of Congress, and treaties no language *providing* his desired rule of decision. He could, however, have found provisions in the Constitution and acts of Congress *requiring* it. Reading Article I's Commerce Clause with Article III's Diversity Clause, the statutes creating and conferring diversity jurisdiction upon lower federal courts,¹¹⁷ and Article VI's Supremacy Clause he might have begun:

[I]t is a question in which the nation as a whole is interested. It enters into the commerce of the country. Commerce between the States is a matter of national regulation, and to establish it as such was one of the principal causes which led to the adoption of our Constitution.¹¹⁸

text; *see also infra* pp. 259-62, for some evidence that the United States Supreme Court has, upon occasion, done something at least arguably very like drawing upon "the equity" of the Constitution and acts of Congress.

¹¹⁶ 41 U.S. (16 Pet.) 1 (1842).

¹¹⁷ *But see* *Suydam v. Williamson*, 65 U.S. (24 How.) 427, 433 (1861) ("The power to establish federal courts, and to endow them with a jurisdiction to determine controversies between certain parties, affords no pretext for abrogating any established law of property . . ."). This, however, can be read as leavening the federal constitutional oversight of interstate commerce with a federal constitutional proscription of the disappointment of vested expectations, rather than with any special concern for the balance between state and federal authority.

¹¹⁸ *Baltimore & Ohio R.R. Co. v. Baugh*, 149 U.S. 368, 378 (1893).

"[I]n a litigation growing out of . . . the citizenship of the parties," he might have continued,

the plaintiff has a right, under the Constitution of the United States, to the independent judgment of those courts, to determine for themselves what is the law of the State, by which his rights are fixed and governed. It was to that very end that the Constitution granted to citizens of one State, suing in another, the choice of resorting to a federal tribunal.¹¹⁹

"[O]n a question of general commercial law," he might have concluded,

the Federal courts administering justice in New York have equal and co-ordinate jurisdiction with the courts of that State. And in deciding a case which involves *a question of such importance to the whole country*; . . . we should not feel satisfied without being able to place our decision upon grounds satisfactory to ourselves, and resting upon what we consider sound principles of law.¹²⁰

In saying these things, he would have invoked federal policies underlying federally enacted texts arguably compelling enough to *require* a single rule of decision in federal courts throughout the United States.

By its own lights, as tradition would have it, *Swift v. Tyson* might have to come out the other way after *Erie Railroad Co. v. Tompkins*.¹²¹ To reiterate, *Swift's* interpretation of the Rules of Decisions Act turned upon the meaning of "laws" in "[t]he laws of the several states."¹²² In *Swift's* own day, ac-

¹¹⁹ *Carroll County v. Smith*, 111 U.S. 556, 563 (1884). To assume the authority "to determine for themselves what is the law of the State" suggests an understanding inconsistent with the application of the *provide-or-require* analysis proposed here. But then, unless qualified, it also suggests an understanding inconsistent with *Swift* doctrine. And finally, it permits an alternative interpretation in line with *provide-or-require* analysis: under the Supremacy Clause, federal law is state law.

¹²⁰ *Railroad Co. v. Lockwood*, 84 U.S. (17 Wall.) 357, 367-68 (1873) (emphasis added).

¹²¹ 304 U.S. 64 (1938). I say "might have," because Justice Story, in *Swift*, deemed the New York decisions unsettled. See *Swift*, 41 U.S. at 16-18.

¹²² *Swift*, 41 U.S. at 18. *Provide-or-require* exegesis also needs a definition of

according to Justice Story, "laws" did not include court decisions interpreting the common law.¹²³ By *Erie*'s day, the fashion in jurisprudence had changed.¹²⁴ Had the *Erie* Court looked to "[t]he laws of the several states" for its rule of decision on the facts of *Swift*, it would have found not an omnipresent commercial law brooding in the sky,¹²⁵ but New York state decisional law that, even if not settled,¹²⁶ was controlling by the 20th Century's popular definition of "law." Arguably, Justice Story decided as he did not so much in disrespect of all state law, as in disrespect of all court decisions—state, federal, or foreign—as "law."

b. Pre-Swift Cases

Of the pre-*Swift* decisions examined, only five opinions so much as cited section 34.¹²⁷ Another few contained language suggesting a Justice might have had it more or less in

the word "laws," but only after the *provide-or-require* switch has opened the gate to "[t]he laws of the several states . . . in cases where they apply. *Id.* We may never know how consciously, if at all, Justice Story looked for federally enacted texts.

¹²³ But see 2 CROSSKEY, *supra* note 24, at 858:

"[J]ustice Story did not found the Court's decision upon any mere notion, right or wrong, of "the nature of law," at all [H]e did not commit the ridiculous error of founding a decision as to the meaning of section 34 upon any abstruse notion of juristic metaphysics. That he left for the naivete and ignorance of later times).

Id.

¹²⁴ See, e.g., FREYER, *supra* note 24, at 96-99, 121-22; RITZ, *supra* note 24, at 159; Hill, *supra* note 5, at 443 ("[T]he difference between *Swift v. Tyson* and *Erie R.R. v. Tompkins* reflects essentially a changed jurisprudence rather than a changed view of the Constitution.").

¹²⁵ *Southern Pac. Co. v. Jensen*, 244 U.S. 205, 222 (1917) (Holmes, J., dissenting) ("The common law is not a brooding omnipresence in the sky but the articulate voice of some sovereign or quasi-sovereign that can be identified It always is the law of some state. . . .").

¹²⁶ See CHEMERINSKY, *supra* note 6, § 5.3 at 273-75.

¹²⁷ *Ross v. Duval*, 38 U.S. (13 Pet.) 45, 60 (1839); *Hawkins v. Barney's Lessee*, 30 U.S. (5 Pet.) 457, 464 (1831); *M'Cluny v. Silliman*, 28 U.S. (3 Pet.) 270, 277 (1830); *Wayman v. Southard*, 23 U.S. (10 Wheat.) 1, 24-26 (1825) (explicating section 34 for first time); *Robinson v. Campbell*, 16 U.S. (3 Wheat.) 212, 221 (1818).

mind.¹²⁸ On the other hand, in *Townsley v. Sumrall*, Justice Story relied pointedly on "the general custom of merchants in the United States,"¹²⁹ concluding, it seems, that the custom of merchants, the law of Kentucky, and the law of Louisiana happily coincided.

Nevertheless, though the Court had not honored section 34 much by name, it had, apparently, with a few exceptions like *Townsley*, imbibed its spirit. Or perhaps both the Justices and section 34 reflected the spirit of their time.¹³⁰ However that may be, most pre-*Swift* decisions, if indeed not all of them, would have lent themselves comfortably to explicit *provide-or-require* reasoning.

¹²⁸ See, e.g., *Jackson v. Chew*, 25 U.S. (12 Wheat.) 153, 162 (1827) ("[T]he rule which has uniformly governed this Court, that where any principle of law, establishing a rule of real property, has been settled in the State Courts, the same rule will be applied by this court." *Id.* In *Jackson*, Justice Thompson went on to say, "This is a principle so obviously just, and so indispensably necessary, under our system of government, that it cannot be lost sight of." *Id.* This qualification may prompt some to wonder whether Justice Thompson had section 34 or some more profound source in mind.); see also *Shelby v. Guy*, 24 U.S. (11 Wheat.) 361, 367 (1826) ("the statute law of the States must furnish the rule of decision to this Court, as far as they comport with the Constitution of the United States, in all cases arising within the respective States"); *Elmendorf v. Taylor*, 23 U.S. (10 Wheat.) 152, 160 (1825) (stating that state law interpreted by state courts "is received as true unless they come in conflict with the constitution, laws or treaties of the United States"); *Daly's Lessee v. James*, 21 U.S. (8 Wheat.) 495, 535 (1823) (stating Supreme Court "listens with respect to the adjudications of the Courts of different states, where they apply"); *Sims' Lessee v. Irvine*, 3 U.S. (3 Dall.) 425, 457 (1799) ("rule of decision").

¹²⁹ 27 U.S. (2 Pet.), 170, 180 (1829).

¹³⁰ "[T]he thirty-fourth section of the Judiciary Act . . . has been uniformly held to be no more than a declaration of what the law would have been without it." *Hawkins v. Barney's Lessee*, 30 U.S. (5 Pet.) 457, 464 (1831).

1) *Rule of Local Property—Land Law; State Statutes*¹³¹

Justice Story's category for "rights and titles to [local] things" comprised almost exclusively disputes over titles to frontier land.¹³² Recall also that it overlapped extensively his category for "local statutes."¹³³ In all of the cases in the overlap of these categories, the Justices applied a provision of a state statute as their rule of decision. In most, they followed a forum state statute as interpreted by the forum state's high court.¹³⁴ In one, they applied an uninterpreted forum state statute as they thought the forum state's legislature had intended.¹³⁵ In another, they interpreted the forum state statute as they thought the forum state's legislature had intended, notwithstanding that the state's intermediate appellate court had interpreted the statute differently.¹³⁶

¹³¹ *Elmendorf v. Taylor*, 23 U.S. (10 Wheat.) 152, 158 (1825) (Kentucky statute); *Polk's Lessee v. Wendell*, 18 U.S. (5 Wheat.) 293, 303-04 (1820) (Tennessee and North Carolina statutes); *Shipp v. Miller's Heirs*, 15 U.S. (2 Wheat.) 316, 325 (1817) (Kentucky statute); *Patton's Lessee v. Easton*, 14 U.S. (1 Wheat.) 476, 477 (1816) (Tennessee statute); *Matson v. Hord*, 14 U.S. (1 Wheat.) 130, 132 (1816) (Kentucky statute); *Polk's Lessee v. Wendal*, 13 U.S. (9 Cranch) 87, 98 (1815) (Tennessee statute); *M'Keen v. Delancy's Lessee*, 9 U.S. (5 Cranch) 22, 31 (1809) (Pennsylvania statute); *Huidekoper's Lessee v. Douglass*, 7 U.S. (3 Cranch) 1, 65 (1805) (Pennsylvania statute); *Wilson v. Mason*, 5 U.S. (1 Cranch) 45, 94-95 (1801) (Virginia statute); *Sims' Lessee v. Irvine*, 3 U.S. (3 Dall.) 425, 457 (1799) (Pennsylvania law alluded to was probably statutory).

¹³² It did also contain several ejectment actions turning upon the law of descent or wills. See *Gardner v. Collins*, 27 U.S. (2 Pet.) 58, 84 (1829) (Rhode Island statute of descents); *Jackson v. Chew*, 25 U.S. (12 Wheat.) 153, 167 (1827) (New York case law concerning wills; deference extends beyond "state constructions of their own statutes"); *Daly's Lessee v. James*, 21 U.S. (8 Wheat.) 495, 535 (1823) (Pennsylvania law concerning wills).

¹³³ See *supra* note 91 and accompanying text.

¹³⁴ See, e.g., *Polk's Lessee v. Wendell*, 18 U.S. (5 Wheat.) 293, 303-04 (1820) (Tennessee and North Carolina statutes); *Shipp v. Miller's Heirs*, 15 U.S. (2 Wheat.) 316, 325 (1817) (Kentucky statute); *Polk's Lessee v. Wendal*, 13 U.S. (9 Cranch) 87, 98 (1815) (Tennessee statute); *M'Keen v. Delancy's Lessee*, 9 U.S. (5 Cranch) 22, 32 (1809) (Pennsylvania statute).

¹³⁵ *Wilson v. Mason*, 5 U.S. (1 Cranch) 45, 96 (1801) ("It is apparent throughout the whole act that the legislature never contemplated a survey as being in itself an appropriation of land . . .").

¹³⁶ *Huidekoper's Lessee v. Douglass*, 7 U.S. (3 Cranch) 1, 67 (1805) ("[I]t is much more reasonable to understand the legislature as requiring the residence for that term. . ."). Professor Crosskey presented this decision and its history as

In none of the decisions in this category did an opinion writer cite section 34. In none did the writer begin with an explicit search for provisions and requirements of federally enacted texts. In *Elmendorf v. Taylor*,¹³⁷ as a signal example, Chief Justice Marshall began with "the principle, supposed to be universally recognised, that the judicial department of every government, where such department exists, is the appropriate organ for construing the legislative acts of that government."¹³⁸ "Thus," he offered by way of example,

no Court in the universe, which professed to be governed by principle, would, we presume, undertake to say, that the Courts of Great Britain, or of France, or of any other nation, had misunderstood their own statutes, and therefore erect itself into a tribunal which should correct such misunderstanding. We receive the construction given by the Courts of the nation as the true sense of the law, and feel ourselves no more at liberty to depart from that construction, than to depart from the words of the statute.¹³⁹

"On this principle," he continued, "the construction given by this Court to the constitution and laws of the United States is received by all as the true construction[.]"¹⁴⁰ Finally, he arrived at the point from which *provide-or-require* reasoning would have begun, saying, "[O]n the same principle, the construction given by the Courts of the several States to the legislative acts of those States, is received as true, *unless they come in conflict with the constitution, laws or treaties of the United States*."¹⁴¹ Had he started there, he would have arrived at the

principal evidence of his thesis that the founding generation originally understood the United States Supreme Court to occupy the paramount position of a national supreme court, presiding over a system of nationally uniform law. See 2 CROSSKEY, *supra* note 24, at 719-53.

¹³⁷ 23 U.S. (10 Wheat.) 152 (1825).

¹³⁸ *Elmendorf*, 23 U.S. at 159.

¹³⁹ *Id.* at 159-60.

¹⁴⁰ *Id.* at 160.

¹⁴¹ *Id.* (emphasis added). For earlier opinions by Chief Justice Marshall, see *Matson v. Hord*:

In the construction of an act so interesting to the people of Ken-

same destination. Finding no rule of decision *provided* or *required* by "the constitution, laws or treaties of the United States," he would then have looked to "the law of the several states." The principle of private international law he invoked would have identified this as one of the "cases where they [that is, the real property statutes and statutory constructions of the state wherein the land lies] apply."

Already in 1817, eight years before Chief Justice Marshall wrote his opinion in *Elmendorf v. Taylor*, Justice Story had evidenced a more expansive view of federal judicial power. In *Shipp v. Miller's Heirs*, he wrote:

This is a decision upon a local law, which forms a rule of property; and this court has always held in the highest respect, decisions of state courts on such subjects. We are satisfied it is a reasonable interpretation of the statute, and upon principle or authority see no ground for drawing it into doubt.¹⁴²

"Highest respect?"¹⁴³ "We are satisfied it is a reasonable interpretation?"¹⁴⁴ "We . . . see no ground for drawing it into doubt?"¹⁴⁵ Compare Chief Justice Marshall's conclusion in

tucky, it is of vital importance that principles be adhered to with care, and that as much uniformity as is practicable be observed in judicial decisions. This court has ever sought, with solicitude, for the true spirit of the law, as settled in the state tribunals, and has conformed its judgments to the rules of those tribunals whenever it has been able to find them established.

14 U.S. (1 Wheat.) 130, 132 (1816); see also *M'Keen v. Delancy's Lessee*, 9 U.S. (5 Cranch) 22, 32 (1809) ("[b]ut, in construing the statutes of a state on which land titles depend, infinite mischief would ensue, should this court observe a different rule from that which has been long established in the state . . .").

¹⁴² 15 U.S. (2 Wheat.) 316, 325 (1817).

¹⁴³ *Shipp*, 15 U.S. at 325.

¹⁴⁴ *Id.*

¹⁴⁵ Compare this with the following language from another of Justice Story's opinions: "[T]he title of the parties, being by descent, depends altogether upon the true construction of the statute of descents of Rhode Island, of 1822 If this question had been settled by any judicial decision in the state where the land lies, we should, upon the uniform principles adopted by this Court, recognize that decision as a part of the local law." *Gardner v. Collins*, 27 U.S. (2 Pet.) 58, 84, 84-85 (1829).

Elmendorf v. Taylor: "If, then, this question has been settled in Kentucky, we must suppose it to be rightly settled."¹⁴⁶ Justice Story made no reference to section 34, gave no deference to private international law. For aught that appears in his opinion, the majority could deem a state court construction of a state statute unreasonable and could entertain grounds for drawing a state court construction into doubt without warrant in federally enacted texts. In Justice Story's mind, Chief Justice Marshall's private international law tempered by federation seems, by this one piece of evidence at least,¹⁴⁷ on its way towards becoming national law for litigants of diverse citizenship. Still, the decision in *Shipp v. Miller's Heirs* did honor the state statute and its state court construction, and a hypothetical Justice Story could have explained the outcome by writing that, neither party having cited, nor the Supreme Court having found, federally enacted texts *providing* or *requiring* a certain rule of decision, the Justices next followed section 34's direction to apply state law.

2) Other "Local" Rules of Property—Law of Descent and Wills

Although Justice Story's category for "rights and titles to [local] things" comprised almost exclusively disputes over titles to frontier land, it did also contain several ejectment actions turning upon the law of descent or wills.¹⁴⁸ Although it overlapped extensively with his category for "local statutes,"¹⁴⁹ it did contain several cases in which the Court followed state caselaw not tied to state statutes.

In *Gardner v. Collins*,¹⁵⁰ the Supreme Court took its rule

¹⁴⁶ 23 U.S. (10 Wheat.) 152, 160 (1825).

¹⁴⁷ See *supra* note 144 and accompanying text.

¹⁴⁸ See *Gardner v. Collins*, 27 U.S. (2 Pet.) 58, 84 (1829) (Rhode Island statute of descents); *Jackson v. Chew*, 25 U.S. (12 Wheat.) 153, 167 (1827) (New York case law concerning wills; deference extends beyond "state constructions of their own statutes"); *Daly's Lessee v. James*, 21 U.S. (8 Wheat.) 495, 535 (1823) (Pennsylvania law concerning wills).

¹⁴⁹ See *supra* note 91 and accompanying text.

¹⁵⁰ *Gardner*, 27 U.S. at 58 (Rhode Island statute of descents).

of decision from Rhode Island's statute of descents in deciding a controversy between parties claiming title to land by descent from the same ancestor.¹⁵¹ Once again, Justice Story might have written that, neither party having cited, nor the Court having found, federally enacted texts *providing* or *requiring* a certain rule of decision, he had to follow section 34's direction to apply state law. The parties apparently cited no state court precedents settling the construction of the applicable statute, thus leaving Justice Story to his own devices. The tenor of his long opinion is consistent with the conclusion that he sought to decide as a Rhode Island court might have decided, not as he thought right, although the two happily coincided for him.

Facing the necessity to construe wills in *Daly's Lessee v. James*¹⁵² and *Jackson v. Chew*,¹⁵³ the Court drew its rules of decision from forum state caselaw. For aught that appears in Justice Washington's opinion in *Daly's Lessee*, no state statute underlay the Pennsylvania Supreme Court decision cited and followed by his opinion. The opinion in *Jackson* acknowledged the absence of a state statute, giving Justice Johnson an opportunity to say,

It has been urged, however, at the bar, that this Court applies this principle [of following state court decisions] only to State constructions of their own statutes. . . . But the same rule has been extended to other cases; and there can be no good reason assigned why it should not be, when it is applying settled rules of real property.¹⁵⁴

In both cases, the writers could have written *provide-or-require* opinions by adding one sentence at the beginning: "Neither party having cited, nor the Court having found, federally enacted texts *providing* or *requiring* otherwise, the Court must draw its rule of decision from appropriate state sources."

¹⁵¹ *Id.*

¹⁵² 21 U.S. (8 Wheat.) 495 (1823) (probably Pennsylvania caselaw).

¹⁵³ 25 U.S. (12 Wheat.) 153 (1827).

¹⁵⁴ *Jackson*, 25 U.S. at 167 (concerning New York caselaw which explains that deference extends beyond "state constructions of their own statutes").

3) Local Rule of Property—Copyright

*Wheaton v. Peters*¹⁵⁵ featured combatants known to us as pioneering reporters of the arguments presented and the opinions rendered in early cases heard before the Justices of the United States Supreme Court. Peters himself reported his setback there!

Wheaton sued Peters in the United States Circuit Court for the Eastern District of Pennsylvania, praying that the court enjoin Peters from publishing an abridgment containing Wheaton's reports.¹⁵⁶ The circuit court dismissed Wheaton's bill.¹⁵⁷ On writ of error, the United States Supreme Court remanded the case for further proceedings, namely factual findings regarding Wheaton's compliance with the registration provisions of the Federal Copyright Act of May 30, 1790.¹⁵⁸ After examining an author's copyright under the common law, Justice M'Lean said for the majority:

It is clear, there can be no common law of the United States. The federal government is composed of twenty-four sovereign and independent states; each of which may have its local usages, customs and common law. *There is no principle which pervades the union and has the authority of law, that is not embodied in the constitution or laws of the union.* The common law could be made a part of our federal system, only by legislative adoption.¹⁵⁹

He then held controlling the act of Congress, May 30, 1790, "an act for the encouragement of learning, by securing the copies of maps, charts and books, to the authors and proprietors of such copies, during the times therein mentioned," as authorized by article I, section 8, of the Constitution.¹⁶⁰ He could have converted his opinion to thoroughly Hoffmanesque *provide-or-require* reasoning simply by starting with the controlling federal

¹⁵⁵ 33 U.S. (8 Pet.) 591 (1834).

¹⁵⁶ *Wheaton*, 33 U.S. at 654 (overridden by federal statute).

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 667.

¹⁵⁹ *Id.* at 658 (emphasis added).

¹⁶⁰ *Id.* at 660.

statute rather than saving it for a surprise. Because that statute *provided* or *required* a certain rule of decision, the scholarly canvass of common law copyright was gratuitous. The thrust of Justice Thompson's long dissent seems to have been that Pennsylvania's common law right to copy, although unarticulated by its courts, continued to exist alongside the federal statutory right.¹⁶¹

4) Other "Local" Statutes—Statutes of Limitation

Under section 34, said Justice M'Lean in *M'Cluny v. Silliman*, "the acts of limitations of the several states, *where no special provision has been made by congress*, form a rule of decision in the courts of the United States, and the same effect is given to them as is given in the state courts."¹⁶² "It is not to be questioned," said Justice Johnson in *Hawkins v. Barney's Lessee*, "that laws limiting the time of bringing suit, constitute part of the *lex fori* of every country. . . ."¹⁶³ Thus, in opinions published in 1830 and 1831, respectively, we see first section 34 and then private international law, probably the template for section 34, credited as authority for a choice-of-law decision.

Justice M'Lean's opinion embodied *provide-or-require* reasoning in all but name. Notice how faithfully the syntax of his sentence follows the syntax of section 34 itself. Justice Johnson could have converted his opinion to *provide-or-require* reasoning by adding one sentence at the beginning: "Neither party having cited, nor the Court having found, federally enacted texts *providing* or *requiring* otherwise, the Court must draw its rule of decision from appropriate state sources." The same could be said for the other decisions and opinions turning upon the application of statutes of limitation.¹⁶⁴

¹⁶¹ *Wheaton*, 33 U.S. at 668-98.

¹⁶² 28 U.S. (3 Pet.) 270 (1830) (emphasis added).

¹⁶³ 30 U.S. (5 Pet.) 457 (1831).

¹⁶⁴ See *Green v. Neal's Lessee*, 31 U.S. (6 Pet.) 291 (1832) (Tennessee statute); *Shelby v. Guy*, 24 U.S. (11 Wheat.) 361 (1826) (Tennessee statute); *Murray's Lessee v. Baker*, 16 U.S. (3 Wheat.) 541 (1818) (Georgia statute; "a sensible construction").

5) *Bills of Exchange and Other Commercial Law*

Here we find the antecedents of *Swift v. Tyson* itself, cases turning with few exceptions¹⁶⁵ on the law of commercial paper. And we find that Justice Story exaggerated in claiming that "all the various cases, which have come before us for decision" supported his restatement in *Swift v. Tyson*.¹⁶⁶

Certainly, *Brown v. Van Braam*,¹⁶⁷ an action on bills of exchange, did not support Justice Story's *Swift* opinion. Therein, the Supreme Court affirmed the judgment for Van Braam, holder of the bills, which the United States Circuit Court for the District of Rhode Island had rendered upon distinctive principles of Rhode Island law,¹⁶⁸ seemingly both judge-made commercial law and procedural law. Both parties quoted and argued section 34, Brown arguing that the Justices should apply common law principles of commercial law, which differed from the law of Rhode Island.¹⁶⁹ Justice Wilson did not take the bait. In the first paragraph of a short two-paragraph opinion, he said, "We are unanimously of opinion, that under the laws, and the practical construction of the courts, of *Rhode Island*, the judgment of the Circuit Court ought to be affirmed."¹⁷⁰ Justice Chase "concurred in the opinion of the court; but . . . on common law principles, and not in compliance with the laws and practice of the state."¹⁷¹

In subsequent decisions, however, the Justices more or less collectively took the turn advocated by Justice Chase in *Brown v. Van Braam*. In his report of *Coolidge v. Payson*, Wheaton (or perhaps an editor or annotator) preceded the style of the case by the centered notation "(COMMON LAW)."¹⁷² Payson brought the action on a bill of exchange against Coolidge in a

¹⁶⁵ See, e.g., *Groves v. Slaughter*, 40 U.S. (15 Pet.) 449 (1841); *United States v. Howland & Allen*, 17 U.S. (4 Wheat.) 108 (1819).

¹⁶⁶ *Swift*, 41 U.S. at 18-19.

¹⁶⁷ 3 U.S. (3 Dall.) 344 (1797).

¹⁶⁸ *Brown*, 3 U.S. at 356.

¹⁶⁹ *Id.* at 346.

¹⁷⁰ *Id.* at 356.

¹⁷¹ *Id.*

¹⁷² 15 U.S. (2 Wheat.) 66 (1817).

United States circuit court, which rendered judgment for Payson on a jury verdict.¹⁷³ On writ of error, the United States Supreme Court affirmed.¹⁷⁴ Speaking for himself and his colleagues, Chief Justice Marshall posed the question thus:

Does a promise to accept a bill amount to an acceptance to a person who has taken it on the credit of that promise, although the promise was made before the existence of the bill, and although it is drawn in favour of a person who takes it for a pre-existing debt?¹⁷⁵

Yes, he answered, depending entirely upon the authority of 17th (and 18th?) Century English cases.¹⁷⁶ No one argued contradictory, or any, state law.

Justice Story wrote the opinion in *Townsley v. Sumrall*.¹⁷⁷ Sumrall had sued Townsley in a Kentucky state court upon an alleged verbal promise to accept a certain bill of exchange.¹⁷⁸ Townsley removed the case to the United States Circuit Court for the District of Kentucky.¹⁷⁹ That court rendered judgment on a jury verdict for Sumrall.¹⁸⁰ On writ of error, the Supreme Court affirmed.¹⁸¹ "It is not disputed," wrote Justice Story, "that, by the general custom of merchants in the United States, bills of exchange drawn in one state on another state, are, if dishonored, protested by a notary; and the production of such protest is the customary document of the dishonor."¹⁸² He seems to have reasoned that the custom of merchants, the law of Kentucky, and the law of Louisiana happily coincided to support affirmance.¹⁸³

¹⁷³ *Coolidge*, 15 U.S. (2 Wheat.) at 66-70.

¹⁷⁴ *Id.* at 70, 75.

¹⁷⁵ *Id.* at 70.

¹⁷⁶ *Id.* at 70-75.

¹⁷⁷ 27 U.S. (2 Pet.) 170 (1829).

¹⁷⁸ *Townsley*, 27 U.S. (2 Pet.) at 174-75.

¹⁷⁹ *Id.* at 174.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 174, 185.

¹⁸² *Id.* at 180.

¹⁸³ *Townsley*, 27 U.S. at 181.

Professor Tony Freyer's account of the political and economic pressures culminating in the *Swift* decision makes edifying reading.¹⁸⁴

c. Post-Swift, Pre-Erie Cases

Had their times and their training so moved them, the post-*Swift*, pre-*Erie* Justices might have deemed their behavior *required* by federally enacted texts in all but a few of the cases in which they overrode contending state rules of decision. The words put into the virtual Justice Story's opinion several paragraphs ago came from the pens of other Justices, writing real opinions in cases after *Swift* and before *Erie*.

1) State Constitution or Statute Provided Competing Rule of Decision

In cases turning upon the applicability of a provision of a forum state constitution or statute, the Court might have professed a paramount concern for interstate creditors *required* by the convergence of the Commerce Clause, the Contracts Clause, the Diversity Clause, the statutes creating lower federal courts and diversity jurisdiction, and the Supremacy Clause. The decisions here fall into three categories, the second of which has two subcategories. First, there are the cases in which the Court applied as its rule of decision a provision of a forum state statute according to its settled or most recent interpretation by the forum state's high court. Second, there are the cases in which the Court applied as its rule of decision a provision of a forum state statute as glossed by some interpretation other than the forum state high court's most recent interpretation. In these cases, it applied either an earlier interpretation by the forum state's high court or an interpretation of its own or seemingly of its own. Third, there are several cases in which the Court refused to draw its rule of decision from a forum state statute with no pretense of looking for a permissible construction.

¹⁸⁴ See FREYER, *supra* note 24.

a) *Settled or Latest State Court Interpretation Controlling*

The cases in which the Supreme Court applied as its rule of decision a provision of a forum state statute according to its settled or most recent interpretation by the forum state's high court¹⁸⁵ square easily with *provide-or-require* exegesis. Having looked to the U.S. Constitution, treaties of the United States, and acts of Congress, and having found no form or forms of words *providing* or *requiring* any other rule of decision,¹⁸⁶ the Court would have drawn its rule of decision from the forum state constitution or statute as currently interpreted by the forum state's high court.¹⁸⁷

b) *Earlier State Court Interpretation Controlling*

Next, consider the cases in which the Court applied as its rule of decision a provision of a forum state constitution or statute as glossed by an earlier interpretation by the forum state's high court. As Exhibit A, take the much maligned¹⁸⁸ *Gelpcke*

¹⁸⁵ See *Fairfield v. County of Gallatin*, 100 U.S. 47, 52 (1879); *Township of Elmwood v. Marcy*, 92 U.S. 289, 294 (1875); *Leffingwell v. Warren*, 67 U.S. (2 Black) 599, 693 (1862); *Webster v. Cooper*, 55 U.S. (14 How.) 488, 504 (1852); *Van Rensselaer v. Kearney*, 52 U.S. (11 How.) 297, 318 (1850); *Nesmith v. Sheldon*, 48 U.S. (7 How.) 812, 818 (1849); *Green v. Neal's Lessee*, 31 U.S. (6 Pet.) 291, 298 (1832); *Shipp v. Miller's Heirs*, 15 U.S. 7 (2 Wheat.) 316, 325 (1817); *Patton's Lessee v. Easton*, 14 U.S. (1 Wheat.) 476, 482 (1816); *Matson v. Hord*, 14 U.S. (1 Wheat.) 130, 132 (1816); *Polk's Lessee v. Wendall*, 13 U.S. (9 Cranch) 87, 98 (1815); *M'Keen v. Delancy's Lessee*, 9 U.S. (5 Cranch) 22, 31 (1809).

¹⁸⁶ But see 2 CROSSKEY, *supra* note 24, at 858.

¹⁸⁷ "Having looked to . . . and found no . . . , the Justices would have" In adversary reality, of course, a court would seldom, if ever, begin this way. It would not look for federal law with no contending state law in mind. One party, plaintiff or defendant, depending upon the tactical contingencies, would have called to the court's attention a rule of decision *provided* or *required* by state or federal law; the other would then have responded with a rule of decision *provided* or *required* by federal or state law. With the alternatives before it, the court would then turn its attention to the commands of the federal law. Even so, it would probably assess those in light of the competing commands of state law.

¹⁸⁸ Among primary sources, see, e.g., *Kuhn v. Fairmont Coal Co.*, 215 U.S. 349, 371 (1910) (Holmes, J., dissenting) ("[E]ven the independent jurisdiction of the circuit courts of the United States is a jurisdiction only to declare the law, at least, in a case like the present, and only to declare the law of the state. It is

v. *City of Dubuque*.¹⁸⁹ Decisions of the Iowa Supreme Court in effect at the time Dubuque issued the bonds at issue in the case had held that Iowa cities such as Dubuque had state constitutional authority to do so.¹⁹⁰ In a later decision, not implicating the impairment of the obligation of contracts, the Iowa Supreme Court held otherwise.¹⁹¹ The United States Supreme Court reversed a decision of the United States District Court for the District of Iowa granting the issuers' demurrer and remanded for further proceedings in conformity with its opinion.¹⁹² Justice Swayne wrote:

However we may regard the late case in Iowa as affecting the future, it can have no effect upon the past. "The sound and true rule is, that if *the contract*, when made, was valid by the laws of the State as then expounded by all departments of the government, and administered in its courts of justice, its validity and obligation *cannot be impaired* by any subsequent action of legislation, or decision of its courts altering the construction of the law."¹⁹³

That is, this was not a case in which the latest state court decision in point applied, because to concede its application would impair the obligation of contracts valid when undertaken. From what body of law, however, did the majority get its rule against impairing the obligation of contracts? It might

not an authority to make it. *Swift v. Tyson* was justified on the ground that that was all that the state courts did. But . . . that fiction had to be abandoned and was abandoned when this court came to decide the municipal-bond cases, beginning with *Gelpcke v. Dubuque*." See, e.g., Jackson, *supra* note 5, at 612-13; William H. Rand, Jr., *Swift v. Tyson versus Gelpcke v. Dubuque*, 8 HARV. L. REV. 328 (1895).

¹⁸⁹ 68 U.S. (1 Wall.) 175 (1863).

¹⁹⁰ *Gelpcke*, 68 U.S. (2 Wall.) at 204 (citing *McMillen v. Boyles*, 6 Iowa 305 (1858); *McMillen v. County Judge & Treasurer of Lee County*, 6 Iowa 391 (1858).

¹⁹¹ *Iowa v. City of Wapello*, 13 Iowa 388 (1862) (holding state courts should never set aside acts of legislatures unless they are clearly in conflict with state constitutions).

¹⁹² *Gelpcke*, 68 U.S. (1 Wall.) at 207.

¹⁹³ *Id.* at 206 (emphasis added) (citing *Ohio Life & Trust Co. v. Debolt*, 57 U.S. (16 How.) 416, 432 (1853). The Court did not cite *Swift v. Tyson*. Nor did it mention the Rules of Decision Act.

have drawn it from Iowa law. In *Stokes v. Scott County*,¹⁹⁴ the very decision relied upon by Justice Miller in dissent, the Iowa Supreme Court had shown respect for the rule against impairing the obligation of contracts.¹⁹⁵ If that is what the majority did, it could have donned the kid gloves of comity, choosing to apply the state statute as interpreted by the earlier Iowa decisions, because Iowa law itself required that choice, not because the U.S. Constitution, by happy coincidence, also contained a prohibition against impairing the obligation of contracts. If, however, the majority had found no such prohibition in Iowa law, it could have found its preferred interpretation of the Iowa statute, i.e., its rule of decision, *required* (though certainly not *provided*) by Article I, section 10's Contracts Clause. The question presented required a choice among competing interpretations of an Iowa constitutional provision. The Contracts Clause did not condescend to interpret the Iowa Constitution. What it did do, however, or what the majority might have said it did, was impose an auxiliary choice of law rule *requiring* the choice of one of the competing interpretations. The majority could have seen these competing interpretations: (1) the interpretation provided by a post-issuance decision of the Iowa Supreme Court; (2) the interpretation provided by pre-issuance decisions of the Iowa Supreme Court; (3) its own interpretation. From among these competing interpretations, the majority had to choose one not transgressing the Contracts Clause. The post-issuance decision of the Iowa Supreme Court did transgress the Contracts Clause, *if applied to bonds issued, as the bonds at bar were, before the decision appeared*. This would have left two alternatives, the pre-issuance interpretation by the Iowa Supreme Court or the majority's own interpretation. It need not have seen itself as providing its own interpretation.¹⁹⁶ *The*

¹⁹⁴ 10 Iowa 166 (1859).

¹⁹⁵ In dissent, Justice Miller reported but then ignored the following, "In 1859, in the case of *Stokes v. Scott County*, 10 Iowa, 166, . . . , Judge Stockton said that, in a case like that, where the bonds had not passed into the hands of *bona fide* holders, he felt at liberty to de[c]lare them void." *Id.* at 218 (Miller, J., dissenting) (*italics in original*).

¹⁹⁶ *But see* *Olcott v. Supervisors*, 83 U.S. (16 Wall.) 678, 690 (1872), wherein

Contracts Clause did not require the application of a federal rule of decision. It only required a rule of decision honoring its prohibition. The majority could have seen itself choosing the Iowa Supreme Court's pre-issuance interpretation.¹⁹⁷ That is, reading the *provide-or-require* mandate with "laws . . . where they apply," it might have understood its auxiliary choice of law rule thus: From the competing "laws" of the donor state choose the one not transgressing a federal constitutional provision.¹⁹⁸ Other pre-*Erie* decisions would have squared with *provide-or-require* analysis in substantially the same way.¹⁹⁹

c) Federal Court Supplied Interpretation

More difficult to place, perhaps, are the cases in which the Court seems to have supplied, or thought it supplied, its own interpretation of a controlling state statutory provision. Consider, for example, *Township of Pine Grove v. Talcott*.²⁰⁰ Talcott sued the Township in the United States Circuit Court for the Western District of Michigan to recover the value of bonds issued by the Township to aid the construction of a railroad.²⁰¹ The Township demurred on the ground that, since

the Justices looked not to an earlier state court decision holding a statute valid, but to their own earlier opinion; and *Burgess v. Seligman*, 107 U.S. (17 Otto) 20, 33 (1883) ("The Federal Courts have an independent jurisdiction in the administration of state laws, co-ordinate with and not subordinate to that of the state courts, and are bound to exercise their own judgment as to the meaning and effect of those laws.").

¹⁹⁷ But see *supra* note 196.

¹⁹⁸ Compare James Bradley Thayer, *Gelpcke v. Dubuque: Federal and State Decisions*, in *LEGAL ESSAYS* (Boston 1908) (citing FREYER, *supra* note 24, at 87-88, n.70 at 174).

¹⁹⁹ See *Township of Pine Grove v. Talcott*, 86 U.S. (19 Wall.) 666, 667 (1873); *Olcott v. Supervisors*, 83 U.S. (16 Wall.) 678, 693 (1872); *City of Kenosha v. Lamson*, 76 U.S. (9 Wall.) 477, 481 (1869); *Thomson v. Lee County*, 70 U.S. (3 Wall.) 327, 330 (1865); *Morgan v. Curtenius*, 61 U.S. (20 How.) 1, 3 (1857); *Pease v. Peck*, 59 U.S. (18 How.) 595, 599 (1855). This represents a mere sample of the "approximately three hundred municipal bond cases" brought before the Court in the thirty years following the *Gelpcke* decision. See 2 CHARLES WARREN, *THE SUPREME COURT IN UNITED STATES HISTORY* 532 (rev. ed. 1926). For an account of the economic and social dislocation associated with the bond cases, see FREYER, *supra* note 24, at 60-61.

²⁰⁰ 86 U.S. (19 Wall.) 666 (1873).

²⁰¹ *Talcott*, 86 U.S. (19 Wall.) at 673. See *Town of Concord v. Portsmouth Sav.*

the issuance of the bonds, the Michigan Supreme Court had ruled the statute under which they were issued unconstitutional.²⁰² The circuit court overruled the demurrer, and judgment went for Talcott.²⁰³ On writ of error, the United States Supreme Court affirmed.²⁰⁴ True, the opinion led off with the obligatory *Swift* rationale, saying, "The question before us belongs to the domain of general jurisprudence. In this class of cases this court is not bound by the judgment of the courts of the States where the cases arise. It must hear and determine for itself."²⁰⁵

Then, however, it changed to a course consistent with, if not foreshadowing, *provide-or-require* analysis:

Here, *commercial securities* are involved. When the bonds were issued, there had been no authoritative intimation from any quarter that such statutes were invalid. The *general understanding* of the legal profession *throughout the country* is believed to have been that they were valid. *The National Constitution forbids the States to pass laws impairing the obligation of contracts.* In cases properly brought before us that end can be accomplished unwarrantably no more by judicial decisions than by legislation.²⁰⁶

The link with Article I, section 10's Contracts Clause could scarcely have been more explicit. In stressing that "commercial securities are involved" and conjuring "[t]he general understanding . . . throughout the country," the opinion invoked Article I's Commerce Clause by easy implication. It could have gone on to find its preferred rule of decision *required* by these federal constitutional provisions, but not *provided* by, certainly. Neither the Contracts Clause nor the Commerce Clause condescended to interpret this Michigan statute. What the Court did

Bank, 92 U.S. 625, 630 (1876).

²⁰² Talcott, 86 U.S. (19 Wall.) at 673.

²⁰³ *Id.*

²⁰⁴ *Id.* at 679.

²⁰⁵ *Id.* at 677.

²⁰⁶ Talcott, 86 U.S. (19 Wall.) at 677-78 (emphasis added). The opinion cited *Railroad Co. v. County of Otoe*, 83 U.S. (16 Wall.) 667 (1872), and *Olcott v. Supervisors*, 83 U.S. (16 Wall.) 678 (1872), as conclusive authority.

do, or what the opinion might have said it did, was impose an auxiliary choice of law rule *requiring* the choice of one of the competing interpretations. Here, the Court could have seen these competing interpretations: (1) the interpretation provided by the post-issuance decision of the Michigan Supreme Court; (2) a hypothetical pre-issuance interpretation by the Michigan Supreme Court (herein *Talcott* differs from *Gelpcke*, where there was a real pre-issuance interpretation); or (3) its own interpretation. From among the competing interpretations, it had to choose one not transgressing the Contracts Clause amplified by the Commerce Clause. The interpretation provided post-issuance by the Michigan Supreme Court transgressed both, impairing the obligation of contracts (in itself transgression enough), thereby chilling interstate commerce. This left two alternatives, a hypothetical pre-issuance interpretation by the Michigan Supreme Court or the Supreme Court's own interpretation. Here (and this is what makes the case's appropriate classification difficult to see) the Court's own interpretation stands out like the distractor in a multiple choice question, contending as it does with an evanescent hypothetical decision. But the Court need not have seen itself as choosing its own interpretation.²⁰⁷ The Contracts and Commerce Clauses did not require the application of a federal rule of decision. They only required a rule of decision, whether federal or state, consonant with themselves. Thus, the Court could have seen itself choosing the pre-issuance interpretation.²⁰⁸ That is, reading

²⁰⁷ See FREYER, *supra* note 24, at 62-63 ("[The *Seligman*] decision may have been the Court's attempt at synthesizing the theories developed in *Swift*, *Runnels*, *Tarpley*, and *Dubuque* into a single doctrine that federal judges might apply with certainty."). But see *Olcott v. Supervisors*, 83 U.S. (16 Wall.) 678, 690 (1872) (wherein the Justices looked not to an earlier state court decision holding a statute valid, but to their own earlier opinion); *Burgess v. Seligman*, 107 U.S. (17 Otto) 20, 33 (1883) ("The Federal Courts have an independent jurisdiction in the administration of state laws, co-ordinate with and not subordinate to that of the State Courts, and are bound to exercise their own judgment as to the meaning and effect of those laws.").

²⁰⁸ For a less sanguine view of such a gambit, recall Justice Jackson's concurrence in *United Airlines*:

"The Court's detour follows this itinerary: the federal court is bound by

the *provide-or-require* mandate with "laws . . . where they apply," the Justices might have understood its auxiliary choice of law rule thus: *From the competing "laws" of the donor state choose the one not transgressing a federal constitutional provision.*

d) *Earlier Federal Court Interpretation Apparently Controlling*

Arguably even more difficult to place are cases in which the Supreme Court cited and followed its own prior decision. *Rowan v. Runnels* is such a case.²⁰⁹ Rowan sued Runnels in the Circuit Court for the Southern District of Mississippi to recover upon a promissory note given in consideration of certain slaves sold to the defendant as merchandise and for sale by the plaintiff in 1836.²¹⁰ A provision of the Constitution of Mississippi, effective in May, 1833, prohibited such sales.²¹¹ The Supreme Court of Mississippi had not yet interpreted the provision, when the United States Supreme Court had, in 1841, held, in *Groves v. Slaughter*,²¹² that the provision was not self-executing and therefore, did not prohibit the sales then before it.²¹³ Subsequent both to this decision and to the date of Runnels's promissory note to Rowan, the Supreme Court of Mississippi held the constitutional provision self-executing.²¹⁴ In *Rowan v. Runnels*, the United States Supreme Court declined to apply the Mississippi decision retroactively to invalidate the promissory note before them.²¹⁵ It did, however, acknowledge the Mississippi decision as controlling prospective-

the law of Illinois; Illinois law is wrong; we will remake the law of Illinois to provide the exact opposite to that which the state has provided; then the federal court can apply the law we have remade and pretend it is applying Illinois law."

First Nat'l Bank, Ex'r v. United Airlines, 342 U.S. 396, 401 (1952).

²⁰⁹ 46 U.S. (5 How.) 134 (1847).

²¹⁰ *Rowan*, 46 U.S. (5 How.) at 138.

²¹¹ *Id.*

²¹² 40 U.S. (15 Pet.) 497 (1841).

²¹³ *Groves*, 40 U.S. (16 Pet.) at 499.

²¹⁴ *Id.*

²¹⁵ *Rowan*, 46 U.S. (5 How.) at 139.

ly.²¹⁶ The opinion did not cite *Swift v. Tyson*. Nor did it mention section 34, although the decision and reasoning square with *provide-or-require* analysis. The current Justices were confronted by competing interpretations of the controlling Mississippi constitutional provision by (1) a decision of the United States Supreme Court (*Groves v. Slaughter*)²¹⁷ and (2) later decisions by the Supreme Court of Mississippi. Directed, as they might have said, by the Contracts Clause, they applied the interpretation in effect at the time Runnels gave his promissory note to Rowan, which happened to be an earlier United States Supreme Court decision.²¹⁸ The Court might and should have seen the former decision, not as an independent interpretation, but as a prediction (mistaken, as it turned out) of how the Mississippi Supreme Court would interpret the controlling provision of the Mississippi Constitution.

Compare this with *Fairfield v. County of Gallatin*,²¹⁹ in which the Court did not follow its earlier interpretation of an Illinois state constitutional provision.²²⁰ *Fairfield* commenced his action against Gallatin County in the United States Circuit Court for the Southern District of Illinois to recover on coupons on county bonds issued in aid of railroad construction.²²¹ Following an earlier decision of the United States Supreme Court in *Town of Concord v. Portsmouth Savings Bank*,²²² which had held that an Illinois state constitutional provision enacted after the County's electorate had authorized the bonds, but before the County had issued them, invalidated the bonds, the circuit court rendered judgment for the County.²²³ On writ of error, the United States Supreme Court reversed and remanded with instructions to render judgment for *Fairfield* "on the

²¹⁶ *Id.*

²¹⁷ 40 U.S. (15 Pet.) 497 (1841).

²¹⁸ *Rowan*, 46 U.S. (5 How.) at 139.

²¹⁹ 100 U.S. 47 (1879).

²²⁰ *Fairfield*, 100 U.S. at 50.

²²¹ *Id.* at 48.

²²² 92 U.S. 625 (1876).

²²³ *Fairfield*, 100 U.S. at 50.

findings made."²²⁴ "When we decided *Town of Concord*," wrote Justice Strong,

[w]e were fully aware that it is the peculiar province of the Supreme Court of a State to interpret its organic law, as well as its statutes, and that it is the duty as well as the pleasure of this court to follow and adopt that court's interpretation. But we were not informed, when the case was decided, that any judicial construction had been given to the constitutional provision. It now appears that the Supreme Court of Illinois had previously considered it, and decided that donations, equally with subscriptions, if sanctioned by a popular vote before the adoption of the Constitution, are not prohibited by it, and that they are excepted from the prohibition by the proviso. This was decided by that court in 1874, more than a year before [*Town of Concord*] came before us; but the decision was not called to our notice, and it was not reported until 1877.²²⁵

"There is every reason to believe," continued the opinion, "that the rule has been relied upon, and that on the faith of it many municipal bonds have been issued, bought, and sold in the markets of the country."²²⁶ "At a very early day," said Justice Strong, "it was announced that in cases depending upon the Constitution or statutes of a State, this court would adopt the construction of the statutes or Constitution given by the courts of the State, when that construction could be ascertained."²²⁷

However, he went on,

when the highest court of a State has given different constructions to its Constitution and laws, at different times, and rights have been acquired under the former construction, we have followed that, and disregarded the latter. The present case is not within that exception, for there have been no conflicting interpretations by the state court of the section of the Constitution we are now called upon to construe. And we are

²²⁴ *Id.* at 55.

²²⁵ *Id.* at 50.

²²⁶ *Id.* at 51.

²²⁷ *Id.* at 52.

not constrained to refuse following the decision of the state court in order to save rights acquired on the faith of our ruling in [*Town of Concord*].²²⁸

In support, the opinion appropriately cited *Groves v. Slaughter*,²²⁹ *Rowan v. Runnels*,²³⁰ and *Green v. Neal's Lessee*.²³¹

e) Statutory Provision Rejected On Its Face

The decisions encompassed by the two categories of cases just canvassed were consistent with *Swift* doctrine, as well as with *provide-or-require* reasoning, because they recognized the controlling authority of a state constitutional or statutory provision, even when interpreting the provision, as it might seem to the cynical, according to the opinion writer's wishes. Consider now, however, those several cases in which the Supreme Court refused to draw its rule of decision from a forum state statute with no pretense of looking for a permissible construction. In three, the statute gave way to the imperatives of the Contracts Clause. In a fourth, it gave way to a countermanding rule of "general commercial law," indicated, a *provide-or-require* disciple would suppose, by the Commerce Clause.

Consider first *Bronson v. Kinzie*.²³² In United States Circuit Court for the District of Illinois, Bronson filed a bill to foreclose a mortgage given by Kinzie to secure a loan.²³³ According to Howard's report, "[A]fter the mortgage was made, and before the bill [to foreclose] was filed, the legislature of Illinois . . . passed a law [providing] that mortgagors and judgment creditors should have the same right to redeem mortgaged premises sold by the decree of a court of chancery, that had been given to the debtors and judgment creditors by a previous law."²³⁴ The statute went on to provide "that all

²²⁸ *Fairfield*, 100 U.S. at 52 (emphasis added).

²²⁹ 40 U.S. (15 Pet.) 497 (1841).

²³⁰ 46 U.S. (5 How.) 134 (1847).

²³¹ 31 U.S. (6 Pet.) 291 (1832).

²³² 42 U.S. (1 How.) 311 (1843).

²³³ *Bronson*, 42 U.S. (1 How.) at 311.

²³⁴ *Id.* at 312.

sales of mortgaged property should be made according to the provisions of that act, whether the foreclosure of said mortgage was by judgment at law or decree in chancery."²³⁵ The parties disagreed about what law should apply to sale and right of redemption.²³⁶ The circuit court certified the question to the United States Supreme Court.²³⁷ Chief Justice Taney wrote that the procedures provided by the Illinois acts, although explicitly adopted by an order of the circuit court, could not apply to a contract entered into before the passage of the acts.²³⁸ Upon the points certified, he said, "the question is, whether the laws of Illinois, of the 19th and the 27th of February, 1841, come within *that clause of the 10th section of the 1st article of the Constitution of the United States, which prohibits a state from passing a law impairing the obligation of contracts.*"²³⁹ "Yes," he answered, proceeding, "[a]s concerns the obligations of the contract upon which this controversy has arisen, they depend upon the laws of Illinois as they stood at the time the mortgage deed was executed."²⁴⁰ He continued:

Whatever belongs merely to the remedy may be altered according to the will of the state, *provided the alteration does not impair the obligation of the contract.* But if that effect is produced, it is immaterial whether it is done by acting on the remedy or directly on the contract itself. *In either case it is prohibited by the Constitution.*²⁴¹

Becoming expansive, he said,

[the Contracts Clause] was undoubtedly adopted as a part of the Constitution for a great and useful purpose. It was to maintain the integrity of contracts, and to secure their faithful execution throughout this Union, by placing them *under the protection of the Constitution of the United States.* And it

²³⁵ *Id.*

²³⁶ *Id.* at 311-13.

²³⁷ *Id.* at 311.

²³⁸ *Bronson*, 42 U.S. (1 How.) at 319.

²³⁹ *Id.* at 314 (emphasis added).

²⁴⁰ *Id.* at 315 (emphasis added).

²⁴¹ *Id.* at 316 (emphasis added).

would but ill become this court, under any circumstances, to depart from the plain meaning of the words used.²⁴²

"When this contract was made," he said, returning to the case at hand,

no statute had been passed by the state changing the rules of law or equity in relation to a contract of this kind. [I]t must, therefore, be governed, and the rights of the parties under it measured, by the rules above stated. *They were the laws of Illinois at the time; and, therefore, entered into the contract, and formed a part of it, without any express stipulation to that effect in the deed.*²⁴³

"Mortgages made since the passage of these laws," he concluded, "must undoubtedly be governed by them; for every state has the power to prescribe the legal and equitable obligations of a contract to be made and executed within its jurisdiction."²⁴⁴

The Justices revisited the issue in *McCracken v. Hayward*.²⁴⁵ McCracken had recovered a judgment against Hayward in the United States Circuit Court for the District of Illinois.²⁴⁶ His execution was thwarted by the two Illinois statutes at issue in *Bronson v. Kinzie*, because no one bid two-thirds the assessed value of Hayward's property.²⁴⁷ McCracken then sued out a federal *venditioni exponas*, but the federal marshal refused to execute it, citing the circuit court's adoption of the procedures in the two Illinois statutes.²⁴⁸ McCracken then moved the court for an order to the marshal.²⁴⁹ On certificate of division, the United States Supreme Court remanded with instructions that the circuit court order the marshal to sell Hayward's property for any price.²⁵⁰ Jus-

²⁴² *Id.* at 318 (emphasis added).

²⁴³ *Bronson*, 42 U.S. (1 How.) at 319 (emphasis added).

²⁴⁴ *Id.* at 321.

²⁴⁵ 43 U.S. (2 How.) 608 (1844).

²⁴⁶ *McCracken*, 43 U.S. (2 How.) at 611.

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Id.*

tice Baldwin reaffirmed *Bronson v. Kinzie*.²⁵¹ After some discussion, he said, "[i]t follows that *the law of Illinois now under consideration*, so far as it prohibits a sale for less than two-thirds of the appraised value of the property levied on, *is unconstitutional and void*."²⁵²

He also said that the rule established by the circuit court would not have been valid under Congress's Act of 1828 anyway, because it modified the provisions of the Illinois statutes.²⁵³

The third of these cases, *Von Hoffman v. City of Quincy*,²⁵⁴ also arose in Illinois.²⁵⁵ After the issuance of certain municipal bonds, the Illinois legislature passed a statute limiting so severely the power of municipalities to tax as to make it virtually impossible ever to pay the bonds off.²⁵⁶ The Supreme Court held that, as applied to bonds in force at the time of the act, this statute unconstitutionally impaired the obligation of contracts.²⁵⁷

Consider finally the heady draft served up by the decision and opinion in *Watson v. Tarpley*,²⁵⁸ in which the Court abandoned all pretense of honoring a state statute, if not all pretense of honoring the definition of "laws" laid down in

²⁵¹ *McCracken*, 43 U.S. (2 How.) at 613.

²⁵² *Id.* at 614 (emphasis added).

²⁵³ *Id.* at 616.

²⁵⁴ 71 U.S. (4 Wall.) 535 (1866).

²⁵⁵ *Von Hoffman*, 71 U.S. (4 Wall.) at 548.

²⁵⁶ *Id.* at 549.

²⁵⁷ *Id.* at 555.

²⁵⁸ 59 U.S. (18 How.) 517 (1855). As Dunne explains:

[T]he most significant vindication of Story's views and vision came ten years after his death when the most fundamentalist of Story's states'-rights colleagues, Justice Daniel, refused in *Watson v. Tarpley* to enforce a Mississippi statute which forbade action on bills of exchange until after maturity and thereby precluded suit upon dishonor by nonacceptance. Story had greeted Daniel's appointment to the Court with a de-meaning comment—truly rare for him—on his new associate's capacity, but he could well have reconsidered his comment had he witnessed Daniel's rigorous application of *Swift v. Tyson*.

Swift.²⁵⁹ In the United States Circuit Court for the Southern District of Mississippi, Watson sued Tarpley in assumpsit on a bill of exchange.²⁶⁰ Apparently applying a provision of a Mississippi statute, the circuit court instructed the jury, in effect, that Watson, as indorsee of the bill, had no immediate right of recourse against Tarpley, the drawer, merely upon presentment of the bill to the drawee and refusal of the drawee to accept.²⁶¹ Watson had to prove demand for payment at the maturity of the bill and regular protest and notice after refusal to pay.²⁶² The jury returned a verdict for Tarpley.²⁶³ On Watson's writ of error, the United States Supreme Court reversed and remanded for a new trial, holding the circuit court's instruction erroneous.²⁶⁴ "It is a rule of commercial law," said Justice Daniel, "too familiarly known to require the citation of authorities, or to admit of question, that the payee or indorsee of a bill upon its presentment and upon refusal by the drawee to accept, has the right to immediate recourse against the drawer."²⁶⁵ "The Statute of Mississippi," he concluded,

so far as it may be understood to deny, or in any degree to impair the right of a *non-resident* holder of a bill of exchange, immediately after presentment to, and refusal to accept by the drawee, and after protest and notice, to resort fort[h]with

²⁵⁹ *Watson*, 49 U.S. (18 How.) at 519-21. Or perhaps *Watson v. Tarpley* reflected what Justice Story had planned all along. See, e.g., *Carpenter v. Providence Wash. Ins. Co.*, 41 U.S. (16 Pet.) 495, 511 (1842), wherein he said:

We have not thought it necessary upon this occasion to go into an examination of the cases cited from the New York and Massachusetts reports The questions under our consideration, are questions of general commercial law, and depend upon the construction of a contract of insurance, which is by no means local in its character, or regulated by any local policy or customs.

Id. Compare that assertion with his willingness in *Swift* to consult state law not only for a controlling local statute, but for state judicial evidence of a "positive, fixed, or ancient local usage[.]" *Swift*, 41 U.S. at 18.

²⁶⁰ *Watson*, 59 U.S. (18 How.) at 517.

²⁶¹ *Id.* at 519.

²⁶² *Id.* at 519-20.

²⁶³ *Id.* at 519.

²⁶⁴ *Id.* at 521.

²⁶⁵ *Watson*, 59 U.S. (18 How.) at 519.

to the courts of the United States by suit upon such bill, must be regarded as wholly without authority and inoperative.²⁶⁶

In support of this conclusion, he reasoned:

The general commercial law being circumscribed within no local limits, nor committed for its administration to any peculiar jurisdiction, and the Constitution and laws of the United States having conferred upon the citizens of the several States, and upon aliens, the power or privilege of litigating and enforcing their rights acquired under and defined by that general commercial law, before the judicial tribunals of the United States, it must *follow by regular consequence*, that any state law or regulation, the effect of which would be to impair the rights thus secured, or to divest [sic] the federal courts of cognizance thereof, in their fullest acceptation under the commercial law, must be nugatory and unavailing.²⁶⁷

He need only have added, “[c]ommerce between the States is a matter of national regulation, and to establish it as such was one of the principal causes which led to the adoption of our Constitution,”²⁶⁸ to make clear how little he was following the definition of “laws” laid down in *Swift*, which he cited, and how faithfully he anticipated *provide-or-require* analysis under section 34, which he also cited. Article I’s Commerce Clause, Article III’s Diversity Clause,²⁶⁹ the statutes creating lower federal courts and establishing diversity jurisdiction, and Article VI’s Supremacy Clause—Justice Daniel could have implicated them all by name, had he seen clearly section 34’s *provide-or-require* mandate. Invoking much of the language vouched to warranty in preceding paragraphs herein, he might have found his preferred rule of decision, a rule thought rooted in international commercial practice, *required* by “the Constitution . . . of

²⁶⁶ *Id.* at 521.

²⁶⁷ *Id.* (emphasis added).

²⁶⁸ *Baltimore & Ohio R.R. v. Baugh*, 149 U.S. 368, 378 (1893).

²⁶⁹ “Article III of the Constitution not only vests the federal courts with particular heads of jurisdiction, but also vests them in such matters with the ‘judicial power of the United States.’” Hill, *supra* note 5, at 439. Professor Hill went on to criticize this argument. *Id.* at 440.

the United States [and] Acts of Congress."²⁷⁰ Looking back, we might excusably find ourselves at a loss to explain why *Watson v. Tarpley* did not come to overshadow *Swift v. Tyson* as the *bête noir* of pre-*Erie* jurisprudence. For whatever reason, whether it was the long shadow cast by Justice Story or otherwise, it did not.²⁷¹

2) State Court Decisions Regarding "Local" Law

According to the received wisdom, *Swift* doctrine understood "laws of the several states" to include state court decisions finding and applying "local" law, particularly rules of property. Most, if indeed not all, the old decisions under this heading would have, or certainly could have, come out the same way under *provide-or-require* analysis.²⁷²

Christy v. Pridgeon is a clear example of such a decision.²⁷³ Christy brought an action for trespass to try title in United States District Court for the Eastern District of Texas.²⁷⁴ He claimed title under a grant from the Governor of Coahuila and Texas, made while Texas was a province of Mexico.²⁷⁵ Pridgeon, in defense, assailed the grant as invalid, because (as Christy conceded) it concerned land then bordering the United States, and had not been approved by the Mexican government, as required by the Mexican colonization law of 1824.²⁷⁶ On that ground, the district court refused to admit

²⁷⁰ 28 U.S.C. § 1652 (1994). Our contemporary fedophobes might think this view of *Watson v. Tarpley* foreshadows *Lincoln Mills* with a vengeance. See *Textile Workers Union of Am. v. Lincoln Mills*, 353 U.S. 448 (1957); see also *infra* pp. 270-72. This would not reflect one way or another, however, upon the utility of *provide-or-require* reasoning. We simply know of a certainty that the fedophobes would never find such "judicial activism" required by any reading of the Constitution and statutes of the United States.

²⁷¹ See Justice Roberts's opinion in *Burns Mortgage Co. v. Fried*, 292 U.S. 487, 495 (1934) ("What was there said [*i.e.*, in *Watson v. Tarpley*] on the subject was unnecessary to the decision [*quaere*], and has not been followed in later cases.").

²⁷² See *supra* pp. 206-13.

²⁷³ 71 U.S. (4 Wall.) 196 (1866).

²⁷⁴ *Christy*, 71 U.S. (4 Wall.) at 291.

²⁷⁵ *Id.*

²⁷⁶ *Id.*

Christy's grant in evidence, the jury thereupon found for Pridgeon, and the district court rendered judgment on the verdict.²⁷⁷ On writ of error, the United States Supreme Court affirmed, Justice Swayne writing:

In construing the . . . colonization law of Mexico, the Supreme Court of Texas has repeatedly held that it operated as a prohibition of any grant of land within the littoral or coast leagues mentioned, without the previous assent of the federal executive of Mexico; that such assent was essential to the validity of a grant within those limits, and that such assent was not to be inferred from the existence of the grant, but must be affirmatively established.²⁷⁸

He concluded, "[t]hese decisions have become *a rule of property* in that State, any departure from which would disturb titles to extensive and densely settled districts of country. We receive them, therefore, to quote the language of this court, in *League v. Eger*, 'as having a binding force almost equivalent to positive law.'²⁷⁹

How about that? "[A]lmost equivalent to positive law." Counsel for Christy could not, one supposes, have put forward any federally enacted text *providing* a competing rule of decision. How much better might counsel have fared in advocating a federal provision *requiring* a competing rule of decision? As in *Bronson v. Kinzie*, the opinion might have invoked the Contracts Clause.²⁸⁰ That, however, would have pointed to the same Texas Supreme Court decisions that had won for Pridgeon and his *Swift* analysis. Besides, the Supreme Court might have professed to see this same auxiliary choice of law rule, after all a fairly garden variety application of the principle of *stare decisis*, in Texas jurisprudence. With no conflict of outcomes between competing rules of decision, the Court might have hidden completely behind the shield of comity. The point is, the spotlight that conscious *provide-or-require* thinking calls

²⁷⁷ *Id.*

²⁷⁸ *Id.* at 204.

²⁷⁹ *Christy*, 71 U.S. (4 Wall.) at 204 (emphasis added).

²⁸⁰ See *supra* pp. 226-28.

down upon the field of federally enacted texts would have illuminated no trophy candidate, nor even a provision or provisions *requiring* a different outcome with sufficient plausibility to satisfy the integrity of a conscientious advocate. Failing federally enacted texts *providing* or *requiring* a certain rule of decision, the Court would next have looked to forum state law, where it would have found the same Texas Supreme Court decisions that informed its decision in the real *Christy v. Pidgeon*. It could have invoked them, however, without the ritual acknowledgment that there were state court decisions that weren't "laws" at all, and the ritual assurance not to worry, however, that these really were laws, even though not interpreting a state statutory provision, because they embodied a "rule of property."

*Yates v. Milwaukee*²⁸¹ arguably belongs in the discussion here as well. Yates commenced a suit in the United States Circuit Court for the District of Wisconsin to obtain an injunction against the City of Milwaukee and one Miller, the City's contractor, restraining them from removing Yates's wharf from the Milwaukee River.²⁸² The City relied for authority upon its own ordinance declaring *this* wharf an obstruction to navigation, and a nuisance, and ordering it abated.²⁸³ The circuit court dismissed the bill.²⁸⁴ On appeal, the United States Supreme Court reversed the circuit court "with instructions to enter a decree enjoining the defendants below from interfering with plaintiff's wharf, reserving, however, the right to the city to remove or change it so far as may be necessary to the *actual* improvement of the navigability of the river and UPON DUE COMPENSATION MADE."²⁸⁵ Speaking for himself and his colleagues, Justice Miller said:

[b]ut the mere declaration by the city council of Milwaukee that a certain structure was an encroachment or obstruction

²⁸¹ 77 U.S. (10 Wall.) 497 (1870).

²⁸² *Yates*, 77 U.S. (10 Wall.) at 499-500.

²⁸³ *Id.* at 498.

²⁸⁴ *Id.* at 501.

²⁸⁵ *Id.* at 507.

did not make it so, nor could such declaration make it a nuisance unless it in [*litigated?*] fact had that character. *It is a doctrine not to be tolerated in this country*, that a municipal corporation, without any general laws either of the city or of the State, within which a given structure can be shown to be a nuisance, can, by its mere declaration that it is one, subject it to removal by any person supposed to be aggrieved, or even by the city itself.²⁸⁶

We may never know what source of intolerant and federally binding law Justice Miller had in mind. If, however, he had thought to cite the Rules of Decision Act, which he did not, this might have been the place to do it. No provision of an act of Congress or a treaty of the United States comes to mind. Certain parts of the Fifth Amendment, however, do come to mind: "No person shall be . . . deprived of . . . property, without due process of law; nor shall private property be taken for public use, without just compensation."²⁸⁷

Likewise, the Fourteenth Amendment commands that "[n]o State shall . . . deprive any person of life, liberty, or property, without due process of law."²⁸⁸ Justice Miller may have meant that the City could not constitutionally take Yates's wharf without a judicial proceeding upon due notice at which it would have to show nuisance to a court's satisfaction. This would have answered the City's second line of defense, its insistence "upon the absolute power of the city of Milwaukee, as the repository of the public authority on the subject of wharves, piers, and other matters affecting the navigation of the river within the city limits, to determine the character and location of such structures."²⁸⁹

If that is what he meant, however, he need not have addressed the City's first line of defense, its insistence "upon the want of title in the plaintiff to the *locus in quo*,"²⁹⁰ except per-

²⁸⁶ *Id.* at 505 (bracketed question added; emphasis added).

²⁸⁷ U.S. CONST. amend. V.

²⁸⁸ U.S. CONST. amend. XIV.

²⁸⁹ *Milwaukee*, 77 U.S. at 503.

²⁹⁰ *Id.*

haps to say that the City must have presented that contention for judicial determination as well. But he did address it, and as an independently alternative ground of defense.

Indeed, it is this assailable feature of the opinion that has assured *Yates v. Milwaukee* its place in the history of *Swift-Erie* jurisprudence, although Justice Miller did not cite *Swift* and could not, of course, have cited *Erie*.²⁹¹ In a previous case,²⁹² the Wisconsin Supreme Court had cut the ground from under Yates's trespass action against Judd by finding that Yates's predecessor in interest had, by platting the area as it had, intended to dedicate to public use that part of the lot upon which Judd had entered and excavated.²⁹³ Justice Miller held that the doctrine of collateral estoppel did not preclude Yates from relitigating the factual issue about his predecessor's intention.²⁹⁴ He went further, however, and arguably without need. He concluded that Yates's predecessor could not, as a matter of law, have dedicated the location at issue to public use, because Yates's predecessor in interest did not own it.²⁹⁵ Yates's predecessor did not own it, because that location, now filled, had previously lain within the margin of the stream.²⁹⁶ Although the Wisconsin Supreme Court had held that a riparian owner held title to the middle of the stream,²⁹⁷ the United States Supreme Court had held that under a patent of United States public lands, the patentee held only to the margin of the stream.²⁹⁸

Thus, Justice Miller had opportunities at two points in his opinion to invoke explicitly the *provide-or-require* reasoning he suggested implicitly. He did not. In a world of might-have-beens, he might have. Given the world that has actually been, many readers would probably consider his first opportunity a

²⁹¹ *Id.*

²⁹² *Yates v. Judd*, 18 Wis. 118 (1864).

²⁹³ *Milwaukee*, 77 U.S. at 506.

²⁹⁴ *Id.*

²⁹⁵ *Id.*

²⁹⁶ *Id.*

²⁹⁷ *Walker v. Shepardson*, 4 Wis. 486 (1853).

²⁹⁸ *Railroad Co. v. Schurmeir*, 74 U.S. (7 Wall.) 272, 289 (1868).

stretch. To argue explicitly that the City of Milwaukee had encroached upon Yates's federal constitutional right to due process would have anticipated constitutional doctrines of a later time, indeed, might have anticipated the Fourteenth Amendment itself.²⁹⁹ Taking his second opportunity, however, could have seemed natural in his own time. The federal case upon which he relied, *Railroad Co. v. Schurmeir*,³⁰⁰ rested its decision upon "the several acts of Congress making provision for the survey and sale of the public lands bordering on public navigable rivers, and the legal construction of the patents issued under such official surveys."³⁰¹ A reservation from the margin of the stream, Justice Clifford continued,

in the Acts of Congress, providing for the survey and sale of such lands, must have the same effect as it would be entitled to receive if it were incorporated into the patent, especially as there is nothing in the field-notes, or in the official plat or patent, inconsistent with that explicit reservation.³⁰²

Justice Miller could have cited the same acts of Congress as *providing* or *requiring* his decision.

3) *State Court Decisions Based On Common Law Provided Competing Rule of Decision*

Under the *Swift* doctrine, it was said, federal courts need not defer to state court decisions finding and applying "common law" rules. Notwithstanding the Erie doctrine, the outcomes of at least some of these cases still seem appropriate, or at least defensible, under *provide-or-require* analysis.

Consider, for example, *Baltimore & Ohio Railroad Co. v.*

²⁹⁹ Congress declared the Fourteenth Amendment part of the Constitution of the United States on July 21, 1868. 15 Stat. 709-11 (1868). The Secretary of State ratified certification on July 28, 1868. *Id.* The City of Milwaukee declared Yates's wharf a nuisance and ordered it removed in 1864. *Milwaukee*, 77 U.S. at 498. The report does not show the date on which Yates commenced his suit, but it was probably before July 21, 1868.

³⁰⁰ 74 U.S. (7 Wall.) 272 (1868).

³⁰¹ *Id.* at 288.

³⁰² *Id.*

Baugh.³⁰³ *Baugh*, a railroad fireman, sued his employer in the United States Circuit Court for the Southern District of Ohio to recover damages for injuries sustained on the job.³⁰⁴ Following Ohio state decisional law, the circuit court instructed the jury, in effect, that the fellow servant doctrine did not prevent a decision for *Baugh*.³⁰⁵ The jury returned a verdict for *Baugh* upon which the circuit court rendered judgment.³⁰⁶ Upon writ of error, the United States Supreme Court reversed and remanded for a new trial, at which the court would instruct the jury, in effect, that the fellow servant doctrine might prevent a decision for *Baugh*.³⁰⁷ After reaffirming at great length the proposition that the question before him was one of general law, not local law, and of common law, not statutory law, Justice Brewer went on:

Further than that, it is a question in which the nation as a whole is interested. It enters into the commerce of the country. Commerce between the States is a matter of national regulation, and to establish it as such was one of the principal causes which led to the adoption of our Constitution.³⁰⁸

He elaborated:

To-day, the volume of interstate commerce far exceeds the anticipation of those who framed this Constitution, and the main channels through which this interstate commerce passes are the railroads of the country. Congress has legislated in respect to this commerce not merely by the Interstate Commerce Act and its amendments, but also by an act passed at the last session, requiring the use of automatic couplers on freight cars.³⁰⁹

"The lines of this very plaintiff in error," he said,

³⁰³ 149 U.S. 368 (1893).

³⁰⁴ *Baugh*, 149 U.S. at 369.

³⁰⁵ *Id.* at 370.

³⁰⁶ *Id.*

³⁰⁷ *Id.* at 390.

³⁰⁸ *Id.* at 378.

³⁰⁹ *Baugh*, 149 U.S. at 369 (citation omitted).

extend into half a dozen or more States, and *its trains are largely employed in interstate commerce*. As it passes from State to State, must the rights, obligations and duties subsisting between it and its employees change at every state line? If to a train running from Baltimore to Chicago it should, within the limits of the State of Ohio, attach a car for a distance only within that State, ought the law controlling the relation of a brakeman on that car to the company to be different from that subsisting between the brakemen on the through cars and the company?³¹⁰

In short, as the majority opinion might have said, its chosen rule of decision was *required by* (although certainly not *provided by*) the convergence of the Commerce Clause, Article III's Diversity Clause, the statutes creating lower federal courts and establishing diversity jurisdiction, the Interstate Commerce Act, the Safety Appliances Act, and the Supremacy Clause. Even Justice Field's morally sensitive dissenting opinion³¹¹ could have invoked *provide-or-require* analysis, although the real Justice Field, burdened by the received wisdom, might not have felt at home with it. Most of his opinion met the majority opinion and the *Swift* doctrine head-on.³¹² He did, however,

³¹⁰ *Id.* at 378-79 (emphasis added).

³¹¹ After noting that the *Ross* line of cases seem "most in accordance with justice and humanity to the servants of a corporation," Justice Field commented, "I regret that the tendency of the decision of the majority of the court in this case is in favor of the largest exemptions of corporations from liability." *Id.* at 411 (Field, J., dissenting).

³¹² *Id.* at 390-411 (Field, J., dissenting). Justice Field went on to explain:

In thus instructing the jury the [circuit] court followed the law as settled by the decisions of the Supreme Court of Ohio—in which State the cause of action arose The law of Ohio on the matter under consideration was the law to control. The courts of the United States cannot disregard the decisions of the state courts in matters which are subjects of state regulation. The relations of employes . . . to their principals . . . are matters of legislative control, and are in no sense under the supervision or direction of the judges or courts of the United States. There is no unwritten general or common law of the United States on the subject. *Indeed, there is no unwritten general or common law of the United States on any subject.* The common law may control the construction of terms and language used in the Constitution and statutes of the United

invoke the Tenth Amendment³¹³ and "the commerce of the country,"³¹⁴ which could have supported textual and policy arguments that federally enacted texts, taken whole, did NOT *require* the rule of decision chosen by the majority.

The decisions in several other "common law" railroad cases could have been decided the same way under a conscious *provide-or-require* calculus, relying on Commerce Clause reasoning as *Baugh* might have.³¹⁵ Cases not implicating railroads might have gone the same route.³¹⁶

Think a moment also about *Kuhn v. Fairmont Coal Co.*,³¹⁷ in which the majority might have relied by name upon the Contracts Clause amplified by Article III's diversity clause and the statutes implementing it. Kuhn sold the coal underlying his land to Fairmont Coal's predecessor in interest.³¹⁸ The contract of conveyance apparently did not provide for subjacent support of the surface interests retained by Kuhn.³¹⁹ Fairmont Coal removed supporting pillars, and Kuhn's land collapsed into the mine.³²⁰ Kuhn commenced his action against Fairmont Coal in United States circuit court, suing in trespass on the case and asserting a right to subjacent support.³²¹ Fairmont Coal set up a decision of the West Virginia Supreme Court, "decided *after* the contract upon which defendant relies was executed, *after* the injury complained of was sustained, and *after* this action was instituted[.]"³²² The cir-

States, but creates no separate and independent law for them.

Id. at 394 (Field, J., dissenting) (emphasis added) (citation omitted).

³¹³ *Baugh*, 149 U.S. at 399 (Field, J., dissenting).

³¹⁴ *Id.* at 406 (Field, J., dissenting).

³¹⁵ See *Beutler v. Grand Trunk Junction Ry.*, 224 U.S. 85 (1912); *Hough v. Texas & Pac. Ry. Co.*, 100 U.S. 213 (1879); *New York Cent. R.R. Co. v. Lockwood*, 84 U.S. (17 Wall.) 357 (1873). Compare *Black & White Taxicab Co. v. Brown & Yellow Taxicab Co.*, 276 U.S. 518 (1928).

³¹⁶ See *Liverpool & G.S. Steam Co. v. Phenix Ins. Co.*, 129 U.S. 397 (1889) (involving ocean transport).

³¹⁷ 215 U.S. 349 (1910).

³¹⁸ *Kuhn*, 215 U.S. at 353.

³¹⁹ *Id.* at 353-54.

³²⁰ *Id.* at 354.

³²¹ *Id.*

³²² *Id.* at 356.

cuit court sustained Fairmont Coal's demurrer to Kuhn's declaration.³²³ On appeal, the United States Court of Appeals for the Fourth Circuit certified to the United States Supreme Court the question whether the West Virginia Supreme Court decision argued by Fairmont Coal bound its decision in Kuhn's case.³²⁴ The majority *held* that it did not, relying upon the line of cases refusing to follow intervening state court interpretations of constitutions and contracts, when to do so would unsettle pre-existing contract rights.³²⁵ "If," said Justice Harlan,

before the rights of the parties in this case were fixed by written contract, it had become a settled rule of law in West Virginia, as manifested by decisions of its highest court, that the grantee or his successors in such a deed as is here involved, was under no legal obligation to guard the surface land of the grantor against injury resulting from the mining and removal of the coal purchased, a wholly different question would have been presented.³²⁶

Invoking "the duty of the Federal court to exercise its independent judgment where there had not been a decision of the state court, on the question involved, *before the rights of the parties accrued*,"³²⁷ he quoted from an earlier decision,

It was not a rule previously established, so as to have become recognized as settled law, and which, of course, all parties to transactions afterwards entered into would be presumed to know and to conform to. When, therefore, it is presented for application by the courts of the United States, in a litigation growing out of the same facts, of which they have jurisdiction by reason of the citizenship of the parties, *the plaintiff has a right, under the Constitution of the United States*, to the independent judgment of those courts, to determine for themselves what is the law of the state, by which his rights are

³²³ *Kuhn*, 215 U.S. at 354.

³²⁴ *Id.* at 355.

³²⁵ *Id.* at 360; see also *supra* pp. 198, 202 at n.111, 217-28.

³²⁶ 215 U.S. at 361.

³²⁷ *Id.* at 366 (emphasis added).

fixed and governed. *It was to that very end that the Constitution granted to citizens of one State, suing in another, the choice of resorting to a Federal tribunal.*³²⁸

Thus, just as the majority might have seen the Commerce Clause as the major ingredient in the federal recipe *requiring* its rule of decision in *Baugh*, it might have seen the Contracts Clause as the major ingredient in *Kuhn*.

Notwithstanding its apparent feats of harmonizing power, the *provide-or-require* mandate would arguably have required some post-*Swift* decisions to come out the other way. They coincide eerily with the decisions deemed most problematic by others on *Erie* grounds.

Amongst them sticks the notorious "last straw"³²⁹ among *Swift's* wild oats, *Black & White Taxicab Co. v. Brown & Yellow Taxicab Co.*³³⁰ itself. By contract, the L & N Railroad

³²⁸ *Id.* (emphasis added) (quoting from *Carroll County v. Smith*, 111 U.S. 556, 563 (1884) (unanimous decision). The *Kuhn* majority sent the usual contradictory signal, however, when it said, "The law which governs the case is the common law, on which this court has never acknowledged the right of the state courts to control our decisions. . . ." 215 U.S. at 364 (quoting from *Yates v. Milwaukee*, 77 U.S. (10 Wall.) 497, 506 (1870)). A citation to *Swift v. Tyson* and the Rules of Decision Act appeared in the majority's opinion only in passing, occurring in a quotation from yet another opinion. *Kuhn*, 215 U.S. at 363. In his dissenting opinion, however, Justice Holmes said:

I admit that plenty of language can be found in the earlier cases to support the present decision. That is not surprising in view of the uncertainty and vacillation of the theory upon which *Swift v. Tyson*, and the later extensions of its doctrine have proceeded . . . [E]ven the independent jurisdiction of the Circuit Courts of the United States is a jurisdiction only to declare the law, at least in a case like the present, and only to declare the law of the state. It is not an authority to make it. *Swift v. Tyson* was justified on the ground that that was all that the state courts did. But . . . that fiction had to be abandoned and was abandoned when this court came to decide the municipal bond cases, beginning with *Gelpcke v. Dubuque*.

215 U.S. at 370-71 (Holmes, J., dissenting) (citations omitted). Seeing *Swift* and post-*Swift* decisions and opinions through the lens of *provide-or-require* thinking reduces, at least arguably, the "uncertainty and vacillation" perceived by Justice Holmes. It also makes *Gelpcke* and the other municipal-bond cases appear less deviant than Justice Holmes apparently considered them. *But see* BRIDWELL & WHITTEN, *supra* note 24, at 115-27; Rand, *supra* note 172.

³²⁹ See Clark, *supra* note 5, at 277.

³³⁰ 276 U.S. 518 (1928). To avoid unfavorable Kentucky law, the Brown & Yel-

Company granted Brown and Yellow exclusive access to the railroad's premises to solicit the transportation of passengers and baggage.³³¹ Black and White intruded to compete with Brown and Yellow, which thereupon obtained a decree from the United States District Court for the Western District of Kentucky enjoining Black and White from interfering with Brown and Yellow's contract.³³² The United States Court of Appeals for the Sixth Circuit affirmed, notwithstanding settled Kentucky case law holding such contracts in restraint of trade and against public policy.³³³ On certiorari, the United States Supreme Court affirmed with Justice Holmes dissenting.³³⁴ Both the majority opinion and the dissent cited *Swift v. Tyson* and the Rules of Decision Act.³³⁵ To finesse the requirements of *Swift* doctrine, the majority distinguished this case out from under a Kentucky constitutional provision that no railway company could make any exclusive or preferential arrangement for handling freight or "for the conduct of any business as a common carrier."³³⁶ It accomplished this by saying: "The contract does not relate to the railroad company's business as a common

low Taxicab Company dissolved its corporate existence under Kentucky law and reincorporated in Tennessee. *Taxicab*, 276 U.S. at 523. This created the diversity of citizenship necessary to bring its case within federal jurisdiction and, as it had hoped, the benign umbrella of *Swift*. *Id.* at 523. According to Professor Tony Freyer:

The taxicab opinion roused enormous criticism. Bills were introduced in Congress to end diversity jurisdiction and wipe out *Swift*. Throughout the nation law professors and attorneys took pen in hand to assail the Court in legal journals. Justice Brandeis wrote Felix Frankfurter of Harvard Law School with a proposed draft of legislation aimed at the doctrine and jurisdiction that had made the taxicab company's maneuver possible.

FREYER, *supra* note 24, at 105.

³³¹ *Black & White Taxicab Co.*, 276 U.S. at 522.

³³² *Id.* at 523-24.

³³³ *Id.* at 520.

³³⁴ *Id.* at 531-32. In dissent, Justice Holmes said: "Whether and how far and in what sense a rule shall be adopted whether called common law or Kentucky law is for the State alone to decide." *Id.* at 534.

³³⁵ *Id.* at 529-30, 535 (quoting KY. CONST. § 214).

³³⁶ *Black & White Taxicab Co.*, 276 U.S. at 526 (quoting KY. CONST. § 214).

carrier.³³⁷ Supposing this to have been the majority's firm understanding of the case before it, not a pretended and opportunistic one, it could not then have said that the Commerce Clause (plus the usual auxiliary provisions of federally enacted texts) *required* its preferred rule of decision. This would have left it with no honest way around certain inconvenient Kentucky state court decisions, which it characterized in the actual event as based upon general law and neutralized by invoking *Swift v. Tyson* and many of its descendants. Of course, had the majority approached the case with *provide-or-require* analysis and a predetermined outcome consciously in mind, it might have concluded that the contract *did* relate to the railroad company's business as an interstate carrier. It could then have concluded, albeit perhaps perversely, that the Commerce Clause, understood á la *Watson v. Tarpley*³³⁸ and *Baltimore & Ohio Railroad Co. v. Baugh*, *required* its preferred rule of decision.

Then, there is *Chicago v. Robbins*.³³⁹ Chicago sued Robbins in Illinois state court to recover damages paid to a pedestrian for injuries sustained when the pedestrian fell into an unguarded excavation on the sidewalk in front of Robbins's building site.³⁴⁰ Robbins removed the case to the United States Circuit Court for the Northern District of Illinois.³⁴¹ In due course, that court rendered judgment on a jury verdict for Robbins.³⁴² On writ of error, the United States Supreme Court reversed and remanded for a new trial on the ground that the circuit court had erred in instructing the jury to find for Robbins if it found his contractor in control of the premises and responsible for the work at the time of the pedestrian's injury.³⁴³ In so instructing, the trial judge had apparently followed a reported decision of an Illinois state appellate court,

³³⁷ *Id.* at 526.

³³⁸ 59 U.S. (18 How.) 517 (1855).

³³⁹ 67 U.S. (2 Black) 418 (1862).

³⁴⁰ *Robbins*, 67 U.S. at 419-20.

³⁴¹ *Id.* at 419.

³⁴² *Id.*

³⁴³ *Id.* at 429.

rather than the United States Supreme Court's view of the better common law rule.³⁴⁴ Said Justice Davis, "[W]here private rights are to be determined by the application of common law rules alone, this Court, although entertaining for State tribunals the highest respect, does not feel bound by their decisions."³⁴⁵ The opinion cited neither *Swift v. Tyson* nor the Rules of Decision Act. Today, *Chicago v. Robbins* would have to come out the other way, whether under *provide-or-require* analysis or Erie doctrine. For aught that appears in the opinion, the rule of decision apparently established by the Illinois state appellate court transgressed neither the Commerce Clause nor the Contracts Clause. Without one or the other of those staple provisions, the opinion would have had to argue that Article III's Diversity Clause, and the statutes creating lower federal courts and establishing diversity jurisdiction, clustered alone, *required* its preferred rule of decision. I leave it to more dedicated fedophiles than myself to maintain that proposition.

B. Erie

Readers who cannot recall a word of section 1652 may nevertheless know *Erie Railroad Co. v. Tompkins*³⁴⁶ by heart. Still, who can resist the urge to rehearse it again? Harry Tompkins, a citizen of Pennsylvania, brought his action against the Erie Railroad Company, a New York corporation, in the United States District Court for the Eastern District of New York to recover money damages for personal injuries suffered while walking on a footpath alongside Erie's moving train in Pennsylvania. Tompkins did not assert gross negligence or willful misconduct.³⁴⁷ Over Erie's contention that Tompkins had been a trespasser on its right-of-way under Pennsylvania case law, the district court instructed the jury that Tompkins had been a licensee under the majority and better common law

³⁴⁴ *Id.*

³⁴⁵ *Robbins*, 67 U.S. at 428-29.

³⁴⁶ 304 U.S. 64 (1938).

³⁴⁷ *Erie*, 304 U.S. at 69.

rule of decision.³⁴⁸ From a judgment on the jury's verdict for Tompkins, Erie appealed to a panel of the United States Court of Appeals for the Second Circuit, which affirmed.³⁴⁹ On writ of certiorari, the United States Supreme Court reversed and remanded for a new trial at which Pennsylvania's case law would provide the rule of decision establishing Tompkins's status on Erie's right-of-way.³⁵⁰ Although Justice Brandeis improvidently staked out much more, the majority could have justified its decision by saying, contrary to time's gloss on *Swift v. Tyson*, "that the words 'the laws' [in the Rules of Decision Act] include in their meaning the decisions of the local tribunals."³⁵¹ Although many post-*Swift* opinions implicating the choice of rules of decision in federal courts had omitted even to mention *Swift*, Justice Brandeis broadsided it.³⁵² Although many post-*Swift* decisions had failed to cite the Rules of Decision Act at all, Justice Brandeis set it out verbatim.³⁵³ But the lipservice fell far short of deference. Instead of focusing upon *Swift*'s now outdated interpretation of the Act's words (a task which Justice Frankfurter later took upon himself in *Guaranty Trust Co. v. York*³⁵⁴), he recited a litany of "the mischievous results of the doctrine."³⁵⁵

Had he reflected in the shadow of a different history, or of no history at all, Justice Brandeis might have justified his desired outcome by conscious *provide-or-require* reasoning. Guided by the Rules of Decision Act, and uninformed by the decisions in the earlier interstate railroad cases,³⁵⁶ he might have

³⁴⁸ *Id.* at 70.

³⁴⁹ *Tompkins v. Erie R.R. Co.*, 90 F.2d 603 (2d Cir. 1937).

³⁵⁰ *Erie*, 304 U.S. at 80.

³⁵¹ *Id.* at 91 (Reed, J., concurring).

³⁵² "If only a question of statutory construction were involved, we should not be prepared to abandon a doctrine so widely applied throughout nearly a century. But the unconstitutionality of the course pursued [under *Swift*] has now been made clear and compels us to do so." *Id.* at 77-78 (footnote omitted).

³⁵³ *Id.* at 78.

³⁵⁴ 326 U.S. 99, 101-03 (1945). See *infra* pp. 263-65, 267.

³⁵⁵ *Erie*, 304 U.S. at 74-77.

³⁵⁶ See *Black & White Taxicab Co. v. Brown & Yellow Taxicab Co.*, 276 U.S. 518 (1928); *Beutler v. Grand Trunk Junction New York Cent. R.R. Co.*, 224 U.S. 85 (1912); *Baltimore & Ohio R.R. v. Baugh*, 149 U.S. 368 (1893); *Railroad Co. v.*

found nothing in the U.S. Constitution, treaties of the United States, acts of Congress, or rules adopted by and within the authority of valid acts of Congress, *providing or requiring* a single rule of decision for all federal courts about the tort duties of interstate railroads. At the same time, his eye might have fallen upon the Tenth Amendment, a text *requiring* "the proper distribution of judicial power between State and federal courts."³⁵⁷ Or, confronted by those early interstate railroad cases, interpreted as decisions *required* by federally enacted texts, he might have overruled them, rather than *Swift v. Tyson*, holding them to have read too broadly what the Commerce Clause and its supporting cast of provisions *required*, when read in light of the Tenth Amendment. Or, he might have deemed it necessary to overrule *Swift*, as well, interpreted as a decision *required* by federally enacted texts, when read in light of the Tenth Amendment. From whichever of the three he started, he would then have looked to "the laws of the several states, . . . in cases where they apply," in this case, the laws of the state of New York, the forum jurisdiction. There he would have found that New York law referred him to the law of Pennsylvania, the state in which the accident occurred.³⁵⁸ Pennsylvania case law would have deemed *Tompkins* a trespasser and disallowed recovery for simple negligence.³⁵⁹

On the other hand, as conscious *provide-or-require* disciples, the dissenters might have argued for overriding state law under the authority of the Commerce Clause and its supporting

Lockwood, 84 U.S. (17 Wall.) 357 (1873).

³⁵⁷ *York*, 326 U.S. at 109. *But see supra* note 29 and accompanying text.

³⁵⁸ *See, e.g., Benton v. Safe Deposit Bank*, 174 N.E. 648, 649 (N.Y. 1931); *Fitzpatrick v. International R.R.*, 169 N.E. 112, 115 (N.Y. 1929). This remained the law of New York until overruled in *Babcock v. Jackson*, 191 N.E.2d 279 (N.Y. 1963). In looking to the whole law of New York in this way, Justice Brandeis would have anticipated the *Erie*-tied holding in *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941) (holding "[t]he laws of the several states" include rules about choice of law).

³⁵⁹ *See, e.g., Koontz v. Baltimore & Ohio R.R. Co.*, 163 A. 212 (Pa. 1932); *Falchetti v. Pennsylvania R.R. Co.*, 160 A. 859 (Pa. 1932). There may have been contraindicative precedents. *See Tompkins v. Erie R.R. Co.*, 90 F.2d 603, 604 (2d Cir. 1937).

provisions, seeing the facts of *Erie* as posing only an easy stretch from *Baugh* and its fellows,³⁶⁰ and no stretch at all from *Watson* and the *Taxicab* case.³⁶¹

In summary, the majority unwittingly laid the groundwork mid-opinion for an explicit *provide-or-require* exegesis of section 1652 when it said, "[e]xcept in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state."³⁶² But the rest of the opinion, fore and aft respectively, worried about "equal protection of the law"³⁶³ and protection against federal encroachment of "rights which in our opinion are reserved by the Constitution to the several States."³⁶⁴ These concerns, later dubbed "the twin aims of the *Erie* rule[,] "³⁶⁵ have continuing constitutional vitality.³⁶⁶ The enduring cogency of the second concern prompted Professor Wright to say, "[T]he significance of the *Erie* doctrine in defining the relationship and division of decision-making authority between the two court systems and two bodies of law—federal and state—will remain."³⁶⁷ These concerns have their roots in constitutional principle and in the Rules of Decision Act, not in *Erie* doctrine.³⁶⁸ They will survive not only the confusion sown by *Erie*'s inartful language, but the appellation "*Erie* doctrine" itself. They would and

³⁶⁰ See *Beutler v. Grand Trunk Junction Ry.*, 224 U.S. 85 (1912); *Liverpool & G.W. Steam Co. v. Phenix Ins. Co.*, 129 U.S. 397 (1889); *Railroad Co. v. Lockwood*, 84 U.S. (17 Wall.) 357 (1873).

³⁶¹ Professor Crosskey might well have applauded this. See 2 CROSSKEY, *supra* note 24.

³⁶² *Erie*, 304 U.S. at 78.

³⁶³ *Id.* at 75.

³⁶⁴ *Id.* at 80.

³⁶⁵ *Hanna v. Plumer*, 380 U.S. 460, 468 (1965). I have, I confess, retinkered the "twin aims" a little. As laid out in *Hanna*, they overlapped much to the detriment of their utility.

³⁶⁶ But see Ely, *supra* note 1, at 713 ("[B]ut surely [*Erie*'s invocation of equal protection] was a metaphor.").

³⁶⁷ 19 CHARLES ALAN WRIGHT, ARTHUR R. MILLER, & EDWARD H. COOPER, *FEDERAL PRACTICE AND PROCEDURE* § 4501 at 2-3 (2d ed. 1996).

³⁶⁸ Recall Justice Harlan's allusion to "the principles which ultimately are the wellsprings both of the Rules of Decision Act and of the *Erie* doctrine." *Commissioner v. Estate of Bosch*, 387 U.S. 456, 477 (1966) (Harlan, J., dissenting).

should factor into the solutions of an explicit *provide-or-require* calculus. Whether by design or happy accident, section 1652 monitors them both.

C. Cases After Erie

In some of their post-*Erie* opinions, the Supreme Court did not even cite the Rules of Decision Act. In none did they really give the Act serious consideration.³⁶⁹ Had they done so, they could have found rules of decision *provided* or *required* by "the Constitution or treaties of the United States or Acts of Congress."³⁷⁰

Setting aside for another time any developed inquiry into rules of decision *provided* or *required* by treaties,³⁷¹ Part C will examine rules of decision suggested by the United States Constitution, rules of decision suggested by reading the United States Constitution and acts of Congress broadly together, and rules of decision suggested by more or less focused attention upon an act or acts of Congress.

This study employs neither of the canonical schemes as a fundamental dichotomy. Section 1652 provides neither the substance-procedure distinction nor the diversity-other distinction. The scheme (or nonscheme, as it were) followed here recognizes the substance-procedure distinction so far as section 2072 requires and no further. A federal court depending upon its "arising under" jurisdiction will already have consulted federally enacted texts in deciding in favor of its jurisdiction,

³⁶⁹ *But see* DelCostello v. International Bhd. of Teamsters, 462 U.S. 151, 172-74 (1942) (Stevens, J., dissenting); *infra* pp. 271-72; United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979); *infra* pp. 274-76.

³⁷⁰ 28 U.S.C. § 1652 (1994).

³⁷¹ Research has as yet revealed no case in which the rule of decision suggested by a treaty conflicted with a rule of decision suggested by state law. *But see* Trans World Airlines, Inc. v. Franklin Mint Corp., 466 U.S. 243, 276 n.5 (1984) ("The Solicitor General correctly observes: 'The Warsaw Convention is a self-executing treaty that provides a source of rules of decision applicable in United States courts without requiring enactment of any supplementary implementing legislation by Congress.'" (Stevens, J., dissenting)). The majority agreed that the Convention provided its rule of decision, disagreeing only about the content of that rule. *Trans World Airlines*, 466 U.S. at 261.

but so will a federal court depending upon its diversity jurisdiction. In either case, doing so will not have resolved or even necessarily identified all, or even any, of the questions requiring rules of decision bearing upon the post-threshold conduct or merits of the action.³⁷² Thus, the *provide-or-require* mandate requires no special-case treatment for cases or controversies maintainable under any particular head of jurisdiction.

1. *Rules of Decision Suggested by United States Constitution*

a. *United States Constitution, Article I, section 10, cl. 1*
(*Contracts Clause*)

In *United States v. Little Lake Misere Land Co.*,³⁷³ the United States commenced an action in the United States District Court for the Western District of Louisiana to quiet title in real property acquired by authority of the Migratory Bird Conservation Act (MBCA).³⁷⁴ The deeds contained prescriptability provisions upon which the United States relied.³⁷⁵ The district court rendered judgment for the defendant.³⁷⁶ The United States Court of Appeals for the Fifth Circuit affirmed.³⁷⁷ On writ of certiorari, the United States Supreme Court reversed and remanded for rendition of judgment for the United States.³⁷⁸ For the majority, Chief Justice Burger said:

The suggestion is that this Court's decision in *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), compels application of state law here because the Rules of Decision Act, 28 U.S.C. § 1652, requires application of state law in the absence of an *explicit*

³⁷² "Indeed it may be possible to have a nondiversity case where the only rights asserted are state-created rights, where the only legal issues are issues of state law, and where no federal interests are discernible whatever." Hill, *supra* note 5, at 453.

³⁷³ 412 U.S. 580, 590 (1973).

³⁷⁴ 16 U.S.C. § 715 (1985); *Little Lake Misere Land Co.*, 412 U.S. at 582.

³⁷⁵ *Little Lake Misere Land Co.*, 412 U.S. at 504.

³⁷⁶ *Id.*

³⁷⁷ *Id.*

³⁷⁸ *Id.* at 604.

congressional command to the contrary. We disagree.³⁷⁹

He concluded that contractual prescriptability posed a federal question under the MBCA á la *Clearfield Trust*³⁸⁰ and that incorporation of state law in this case, that is, Louisiana Act 315 of 1940, which would have *retroactively* invalidated the contractual prescriptability provisions of these contracts, would not be appropriate.³⁸¹ "[T]he inevitable incompleteness presented by all legislation," he reasoned, "*means that interstitial federal lawmaking is a basic responsibility of the federal courts.*"³⁸² In concurrence, Justice Stewart said: "This retroactive application of Act 315, I believe, is a textbook example of a violation of Article I, § 10, clause 1, of the Constitution, which provides that no State shall pass any law 'impairing the Obligation of Contracts.'"³⁸³

b. Article IV, Section 1 (Full Faith and Credit Clause)

In *Klaxon Co. v. Stentor Electric Manufacturing Co.*,³⁸⁴ the United States District Court for the District of Delaware applied a New York statute providing for prejudgment interest without determining whether a Delaware state court would have chosen the New York statute rather than Delaware law.³⁸⁵ The United States Court of Appeals for the Third Cir-

³⁷⁹ *Id.* at 591 (emphasis added) (footnote omitted).

³⁸⁰ 318 U.S. 363 (1943).

³⁸¹ *Little Lake Misere Land Co.*, 412 U.S. at 595.

³⁸² *Id.* at 593 (emphasis added).

³⁸³ *Id.* at 606 (Stewart, J., concurring). In concurrence, Justice Rehnquist chose another ground, cautioning that Justice Stewart's conclusion seemed doubtful after *Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934). *Little Lake Misere Land Co.*, 412 U.S. at 607 (Rehnquist, J., concurring). In *Blaisdell*, on appeal from a decision of the Minnesota Supreme Court, the Justices held, 5-4, that the Minnesota Mortgage Moratorium Law, which extended the period of redemption under conditions prescribed to protect creditors, did not violate the Contracts Clause. *Blaisdell*, 290 U.S. at 447. In a close call, the majority distinguished *Bronson v. Kinzie*. *Id.* at 431. The Four Horsemen dissented. *Id.* at 398.

³⁸⁴ 313 U.S. 487 (1941).

³⁸⁵ *Klaxon*, 313 U.S. at 495. See *Griffin v. McCoach*, 313 U.S. 498 (1941). Compare *Wells v. Simonds Abrasive Co.*, 345 U.S. 514 (1953).

cuit affirmed.³⁸⁶ The United States Supreme Court granted certiorari and reversed.³⁸⁷ Citing *Erie*, Justice Reed said, "The conflict of laws rules to be applied by the federal court in Delaware must conform to those prevailing in Delaware's state courts."³⁸⁸ The opinion did not cite the Rules of Decision Act, but it might reasonably have reached the same result by conscious *provide-or-require* reasoning. Indeed, a presage of *provide-or-require* reasoning bubbled to the surface when Justice Reed said, "The full faith and credit clause does not go so far as to compel Delaware to apply § 480 [New York law] if such application would interfere with its local policy."³⁸⁹ That is, we might suppose that Justice Reed looked for controlling federally enacted texts and found none. Article IV, Section 1 of the Constitution certainly did not *provide* a rule of decision for the district court, that is, it contains no instructions about computing prejudgment interest. It might arguably have *required* the application of one rule of decision rather than another,³⁹⁰ although Justice Reed concluded otherwise. Only then did the Court look (or might it have looked) to forum state law, finding that Delaware law *provided* or *required* a rule of decision about rules of decision other than the one the district and circuit courts had consciously or unconsciously applied.

³⁸⁶ *Klaxon*, 313 U.S. at 495.

³⁸⁷ *Id.* at 498.

³⁸⁸ *Id.* at 496.

³⁸⁹ *Id.* at 498. In support of affirmance (though not the *Erie* rationale), the opinion did cite then 28 U.S.C. § 811 as reflecting "the traditional treatment of interest [on judgments] in diversity cases," providing as it did that such interest "be calculated from the date of judgment at such rate as is allowed by law on judgments recovered in the courts of the state in which the court is held." *Id.* at 497.

³⁹⁰ See Wolkin, *supra* note 5, at 297 ("There is at least one set of limitations which, though not giving a federal court freedom to formulate conflict rules of its own choosing, does permit it to reject the existing state choice of law rule. The limitations spring from the due process, full faith and credit, and perhaps other provisions of the federal Constitution.") (citing *Home Ins. Co. v. Dick*, 281 U.S. 397 (1930) (due process); *Bradford Elec. Light Co. v. Clapper*, 286 U.S. 145 (1932) (full faith and credit); *Hartford Acc. & Indem. Co. v. Delta & Pine Land Co.*, 292 U.S. 143 (1934) (due process); *Western Union Tel. Co. v. Brown*, 234 U.S. 542 (1914) (commerce powers). For citations to other commentary, see *id.* at nn.24, 25. See Dye, *supra* note 5, at 202 n.31.

c. *Seventh Amendment (Trial by Jury)*

In *Byrd v. Blue Ridge Rural Electric Cooperative, Inc.*,³⁹¹ the Supreme Court also might have supported its decision with conscious *provide-or-require* reasoning. The question was whether a United States district court hearing a worker's personal injury action in South Carolina had to apply a state judge-made rule assigning to the judge, rather than the jury, the determination of a certain affirmative defense.³⁹² Justice Brennan said no, weaving a complicated rationale to get around the "outcome determinative" test introduced in *Guaranty Trust Co. v. York*.³⁹³ Guided by section 1652, he could have found his rule of decision in a provision of the United States Constitution. That is, he could have found his decision *required* by, although not *provided* by, the Seventh Amendment's grant of the right to trial by jury. Indeed, he hinted as much.³⁹⁴ Talk of "outcome determination" would have added nothing *provided* or *required* by the Seventh Amendment, or by any enacted text to which it pointed. As one commentator has suggested, "[d]espite all protestations to the contrary, the concurrence of six Justices in the majority may be explained only by the existence of the seventh amendment."³⁹⁵

The following year, in *Magenau v. Aetna Freight Lines, Inc.*,³⁹⁶ a majority of the Supreme Court invoked *Byrd* without further gloss.³⁹⁷ *Magenau* commenced a wrongful death action against Aetna in the United States District Court for the West-

³⁹¹ 356 U.S. 525 (1958).

³⁹² *Byrd*, 356 U.S. at 527-28.

³⁹³ *Id.* at 539.

³⁹⁴ "[U]nder the influence—if not the command—of the Seventh Amendment, [the federal judicial system] assigns the decisions of disputed questions of fact to the jury." *Id.* at 537 (footnote omitted). And later, "[I]n light of the influence of the Seventh Amendment, the function assigned to the jury 'is an essential factor in the process for which the Federal Constitution provides.'" *Id.* at 539 (citation omitted). See Ely, *supra* note 1, at 709 ("The question presented [in *Byrd*] . . . could have been decided, at least if the subsequent decision in *Simler v. Conner* is to be believed, on Seventh Amendment grounds pure and simple.").

³⁹⁵ Quigley, *supra* note 5, at 1041 (footnote omitted).

³⁹⁶ 360 U.S. 273 (1959).

³⁹⁷ *Magenau*, 360 U.S. at 273.

ern District of Pennsylvania.³⁹⁸ That court rendered judgment on a jury verdict for Magenau.³⁹⁹ The United States Court of Appeals for the Third Circuit reversed, holding Magenau's decedent an employee of Aetna as a matter of law.⁴⁰⁰ On writ of certiorari, the United States Supreme Court reversed, 6-3, holding that, under *Byrd*, the questions necessary to determine whether Magenau's sole remedy lay under Pennsylvania's worker compensation act were for the jury.⁴⁰¹ The dissenters thought the Court should have dismissed the writ of certiorari as improvidently granted, citing the Rules of Decision Act and Erie doctrine more or less incidentally.⁴⁰²

In 1996, in *Gasperini v. Center for Humanities, Inc.*,⁴⁰³ *Byrd* received more attention than it had enjoyed for a long time. The Center for Humanities failed to return 300 photographic slides to Gasperini, who then sued the Center in the United States District Court for the Southern District of New York to recover damages for breach of contract, conversion, and negligence.⁴⁰⁴ The Center conceded liability and a jury returned a verdict for Gasperini in the amount of \$450,000.⁴⁰⁵ The district court denied without comment the Center's motion for a new trial under Rule 59(a) of the Federal Rules of Civil Procedure.⁴⁰⁶ Applying New York's statutory standard for determining excessiveness of jury awards, the United States Court of Appeals for the Second Circuit vacated the judgment and remanded for a new trial, unless Gasperini remitted \$350,000.⁴⁰⁷ That statute provides:

In reviewing a money judgment . . . in which it is contended that the award is excessive or inadequate and that a new

³⁹⁸ *Id.* at 274.

³⁹⁹ *Id.*

⁴⁰⁰ *Id.*

⁴⁰¹ *Id.*

⁴⁰² *Magenau*, 360 U.S. at 284.

⁴⁰³ 518 U.S. 415 (1996).

⁴⁰⁴ *Gasperini*, 518 U.S. at 419.

⁴⁰⁵ *Id.* at 420.

⁴⁰⁶ *Id.*

⁴⁰⁷ *Id.*

trial should have been granted unless a stipulation is entered to a different award, the appellate division shall determine that an award is excessive or inadequate if it *deviates materially* from what would be *reasonable compensation*.⁴⁰⁸

On writ of certiorari, the United States Supreme Court, 5-4, remanded to the court of appeals with instructions to remand to the district court to reassess the verdict for excessiveness under New York's "deviates materially" standard.⁴⁰⁹

The Court unanimously agreed with the court of appeals that, in establishing a heightened standard of review for New York appellate courts, the New York statute implicitly established the same standard for New York trial courts. The majority of them also agreed, without addressing section 1652 or Rule 59(a), that the district court should have applied the New York statutory standard, as interpreted by New York state courts in similar cases, because it "influences outcomes by tightening the range of tolerable awards."⁴¹⁰ The majority disagreed, however, that New York's statutory standard controlled the Second Circuit's standard of review, saying:

Parallel application of § 5501(c) at the federal appellate level would be out of sync with the federal system's division of trial and appellate court functions, an allocation *weighted by the Seventh Amendment*. The dispositive question, therefore, is whether federal courts can give effect to the *substantive thrust* of § 5501(c) without untoward alteration of the federal scheme for the trial and decision of civil cases.⁴¹¹

Reading section 1652 "[a]s *Erie* read the Rules of Decision Act," the opinion continued, "[e]xcept in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the States."⁴¹² Endorsing the lay understanding that, under *Erie*, "federal courts sitting in

⁴⁰⁸ *Id.* at 423 (quoting N.Y.C.P.L.R. § 5501(c)) (emphasis added).

⁴⁰⁹ *Gasperini*, 518 U.S. at 439.

⁴¹⁰ *Id.* at 425 (citation omitted).

⁴¹¹ *Id.* at 426 (emphasis added).

⁴¹² *Id.* at 426-27 (citation omitted) (footnote omitted).

diversity apply state substantive law and federal procedural law[.]” the majority characterized the New York statute as both substantive and procedural.⁴¹³

After saying that here, unlike in *Byrd*, “New York’s dominant interest can be respected, without disrupting the federal system,”⁴¹⁴ the majority concluded, “[i]n light of *Erie*’s doctrine, the federal appeals court must be guided by the damage-control standard state law supplies, but . . . [must review for] ‘abuse of discretion’, not by applying de novo the New York standard],”⁴¹⁵ because “[w]ithin the federal system, practical reasons combine with *Seventh Amendment* constraints to lodge in the district court, not the court of appeals, primary responsibility for application of § 5501(c)’s ‘deviates materially’ check.”⁴¹⁶

Translating the majority’s words (perhaps without the “practical reasons” and “weighted by” hedges) into the vocabulary of *provide-or-require* reasoning, the Seventh Amendment’s second clause (“no fact . . . otherwise re-examined”) *required* federal appellate courts to apply the federally established scope of review for district court decisions about the excessiveness of jury verdicts. However, the Seventh Amendment’s first clause (“right of trial by jury . . . preserved”) did not *require* federal district courts to apply the federally established standard for determining excessiveness. The majority reached this second conclusion in the teeth of its own concession that applying New York’s statutory rule would require district courts sitting in diversity to set aside jury verdicts they would not have set aside sitting other than in diversity. In a dissenting opinion endorsed by Chief Justice Rehnquist and Justice Thomas, Justice Scalia disagreed that a United States district court must apply New York’s statutory standard.⁴¹⁷

⁴¹³ *Id.*

⁴¹⁴ *Gasperini*, 518 U.S. at 437.

⁴¹⁵ *Id.* at 438 (footnote omitted).

⁴¹⁶ *Id.*

⁴¹⁷ *Id.* at 448 (Scalia, J., dissenting). For elaboration of Justice Scalia’s dissent, see *infra* pp. 318-19.

d. *The Fourth Amendment (Searches and Seizures)*

Perhaps the most celebrated decision reading a federal constitutional provision to *require* a certain rule of decision⁴¹⁸ is *Bivens v. Six Unknown Named Agents of the Federal Bureau of Narcotics*.⁴¹⁹ Bivens commenced his action in United States District Court for the Eastern District of New York to recover money damages for violation of his rights under the Fourth Amendment.⁴²⁰ He claimed \$15,000 from each of the six agents for "great humiliation, embarrassment, and mental suffering" inflicted by an unreasonable search and seizure.⁴²¹ The district court dismissed for lack of subject matter jurisdiction and for failure to state a claim.⁴²² The United States Court of Appeals for the Second Circuit affirmed on the ground that Bivens had failed to state a claim.⁴²³ On writ of certiorari, the Supreme Court reversed, 6-3, holding that "violation of [the Fourth Amendment's] command by a federal agent acting under color of his authority gives rise to a cause of action for damages consequent upon his unconstitutional conduct."⁴²⁴ Said Justice Brennan:

Of course, the Fourth Amendment does not in so many words *provide* for its enforcement by an award of money damages for the consequences of its violation. But "it is . . . well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done."⁴²⁵ The present case involves no special factors counselling hesitation in the absence of affirmative action by Congress.⁴²⁶

⁴¹⁸ Actually, this is a decision pertaining to a certain complex of rules, some of which might, upon close examination, draw upon state sources.

⁴¹⁹ 403 U.S. 388 (1971).

⁴²⁰ *Bivens*, 403 U.S. at 389.

⁴²¹ *Id.* at 389-90.

⁴²² *Id.* at 390.

⁴²³ *Id.*

⁴²⁴ *Id.* at 389.

⁴²⁵ *Bell v. Hood*, 327 U.S. 678 (1946).

⁴²⁶ *Bivens*, 403 U.S. at 396 (emphasis added).

The majority opinion made no mention of either *Erie* or the Rules of Decision Act. Justice Harlan cited *Erie* in concurrence.⁴²⁷ None of the three dissenting opinions cited either *Erie* or the Rules of Decision Act.

e. The Eighth Amendment (Cruel and Unusual Punishments)

*Carlson v. Green*⁴²⁸ built upon *Bivens*. Proceeding as administratrix of her deceased son's estate, Green commenced an action in the United States District Court for the Southern District of Indiana against Carlson (as Director of the Federal Bureau of Prisons) and other federal officials to recover money damages for contributing to the death of her son by violating his constitutional rights under the Fifth and Eighth Amendments.⁴²⁹ Although holding that Green's complaint "pleaded a violation of the Eighth Amendment's proscription against infliction of cruel and unusual punishment, giving rise to a cause of action for damages under *Bivens*,"⁴³⁰ the district court dismissed Green's action for lack of subject matter jurisdiction, in that the damages "provided by Indiana's survivorship and wrongful-death laws" did not exceed the then-current \$10,000 jurisdictional-amount requirement.⁴³¹ The United States Court of Appeals for the Seventh Circuit reversed, because "whenever the relevant State survival statute would abate a *Bivens*-type action brought against defendants whose conduct results in death, the federal common law allows survival of the action" permitting the recovery of money damages in excess of \$10,000.⁴³² The Supreme Court granted certiorari and affirmed, 7-2. Writing for himself and four other Justices, Justice Brennan said, "*Bivens* established that the victims of a constitutional violation by a federal agent have a right to recover

⁴²⁷ *Id.* at 400.

⁴²⁸ 446 U.S. 14 (1980).

⁴²⁹ *Carlson*, 446 U.S. at 16.

⁴³⁰ *Id.* at 17 (footnote omitted).

⁴³¹ *Id.*

⁴³² *Id.* at 18 (citation omitted).

damages against the official in federal court despite the absence of any statute conferring such a right.⁴³³ *Bivens* actions, he said:

are a creation of federal law and, therefore, the question whether respondent's action survived Jones' death is a question of federal law. . . . [O]nly a uniform federal rule of survivorship will suffice to redress the constitutional deprivation here alleged and to protect against repetition of such conduct.⁴³⁴

Uniformity, he concluded,

cannot be achieved if courts are limited to applicable state law. . . . [W]henever the relevant state survival statute would abate a *Bivens*-type action brought against defendants whose conduct results in death, the federal common law allows survival of the action.⁴³⁵

Rather than invoking "federal common law," Justice Brennan might have followed section 1652 to the Eighth Amendment, finding that it *required*, although it certainly did not *provide*, a uniform federal rule of decision concerning survival. Justice Rehnquist did cite the Rules of Decision Act in his dissent.⁴³⁶

2. *Rule of Decision Suggested by Reading the United States Constitution and Acts of Congress Broadly Together*

In several opinions, Justices have supported the choice of a federal rule of decision by broad allusions to the Constitution and statutes generally, with no focused citations to chapter and verse. This seems like drawing on "the equity" of the Constitution and acts of Congress, notwithstanding such disclaimers as might appear in the literature.⁴³⁷

⁴³³ *Id.*

⁴³⁴ *Carlson*, 446 U.S. at 23 (citation omitted).

⁴³⁵ *Id.* at 24 (citation omitted).

⁴³⁶ *Id.* at 43-44, 48-49 (Rehnquist, J., dissenting).

⁴³⁷ See Herman, *supra* note 59, at 538 ("Although a search for the statute's 'equity' has become indispensable for civil code readers, English judicial method has traditionally discouraged the technique, at least in the reading of statutes.");

Consider first *Clearfield Trust Co. v. United States*,⁴³⁸ a precedent already famous for its starring role in "federal common law" doctrine. The United States sued Clearfield Trust in the United States District Court for the Western District of Pennsylvania to recover \$24.20 upon Clearfield Trust's express guaranty of its prior endorsement.⁴³⁹ The district court dismissed the complaint, holding

that the rights of the parties were to be determined by the law of Pennsylvania and that since the United States unreasonably delayed in giving notice of the forgery to the Clearfield Trust Co., it was barred from recovery under the rule of [a Pennsylvania Supreme Court decision].⁴⁴⁰

The United States Court of Appeals for the Third Circuit reversed.⁴⁴¹ On certiorari, the United States Supreme Court affirmed.⁴⁴² Justice Douglas wrote:

[T]he rule of *Erie* . . . does not apply to this action. The rights and duties of the United States on commercial paper which it issues are governed by federal rather than local law. . . . The authority to issue the check had its origin in *the Constitution and the statutes of the United States* and was in no way dependent on the laws of Pennsylvania or of any other state. The *duties* imposed upon the United States and the *rights* acquired by it as a result of the issuance *find their roots in the same federal sources*.⁴⁴³

In language set out in the following footnote, the opinion recognized, in effect, that "the Constitution and the statutes of the United States" did not *provide* a rule of decision, but *required* a rule of decision of certain provenance and dimensions.⁴⁴⁴ It

see also *supra* pp. 179-80.

⁴³⁸ 318 U.S. 363 (1943).

⁴³⁹ *Clearfield*, 318 U.S. at 364-65.

⁴⁴⁰ *Id.* at 366. See *Market St. Title & Trust Co. v. Cheltenham Trust Co.*, 145 A. 848 (Pa. 1929).

⁴⁴¹ *Clearfield*, 318 U.S. at 366.

⁴⁴² *Id.*

⁴⁴³ *Id.* (emphasis added) (citations omitted).

⁴⁴⁴ *Id.* The opinion said:

cited two pre-*Erie*, post-*Swift* decisions,⁴⁴⁵ but cited neither *Swift* nor section 34.

Although one might have expected more from a leader of the new textualism, Justice Scalia has afforded us a second example of broad allusions to the Constitution and statutes generally in his opinion for the 5-4 majority in *Boyle v. United Technologies Corp.* (UTC).⁴⁴⁶ Boyle sued UTC in United States district court to recover for the wrongful death of his son, a Marine helicopter copilot, allegedly attributable to a design defect in the helicopter's emergency escape door.⁴⁴⁷ The district court denied UTC's motion for judgment notwithstanding the verdict.⁴⁴⁸ The United States Court of Appeals for the Fourth Circuit reversed.⁴⁴⁹ On certiorari, the Supreme Court vacated and remanded for certification on a point raised in the Court's decision.⁴⁵⁰ In holding a federal rule of decision *required* by "the Constitution and laws of the United States," Justice Scalia said:

In absence of an applicable Act of Congress [*providing* a rule of decision] it is for the federal courts to fashion the governing rule of law according to their own standards In our choice of the applicable federal rule we have occasionally selected state law. But reasons which may make state law at times the appropriate federal rule are singularly inappropriate here. The issuance of *commercial paper* by the United States is on a vast scale and transactions in that paper from issuance to payment will commonly occur in several states. The application of state law, even without the conflict of laws rules of the forum, would subject the rights and duties of the United States to exceptional uncertainty. It would lead to great diversity in results by making identical transactions subject to the vagaries of the laws of the several states. The desirability of a uniform rule is plain. And while the federal law merchant, developed for about a century under the regime of *Swift v. Tyson* represented *general commercial law rather than a choice of a federal rule designed to protect a federal right*, it nevertheless stands as a convenient source of reference for fashioning federal rules applicable to these federal questions.

Id. at 367 (emphasis added) (citations omitted).

⁴⁴⁵ *United States v. National Exch. Bank*, 214 U.S. 302 (1908); *Leather Mfg. Bank v. Merchants Nat'l Bank*, 128 U.S. 26 (1888).

⁴⁴⁶ 487 U.S. 500 (1988).

⁴⁴⁷ *Boyle*, 487 U.S. at 502.

⁴⁴⁸ *Id.* at 503.

⁴⁴⁹ *Id.*

⁴⁵⁰ *Id.*

In most fields of activity, to be sure, this Court has refused to find federal pre-emption of state law in the absence of either a clear statutory prescription or a conflict between federal and state law. But we have held that a few areas, involving "uniquely federal interests," are so committed by *the Constitution and laws of the United States* to federal control that state law is pre-empted and replaced, where necessary, by federal law of a content prescribed (absent explicit statutory directive) by the courts—so-called "federal common law."⁴⁵¹

He cited no particular part of the Constitution. Nor did he cite section 1652. The four dissenters argued that no combination of provisions of federal statutory law *required* the majority to fashion this federal rule of decision in derogation of the tort law of the state of Virginia.⁴⁵² Giving Justice Scalia a dose of his own medicine, three of the dissenting Justices said, "[t]he Court—unelected and unaccountable to the people—has unabashedly stepped into the breach to legislate a rule denying Lt. Boyle's family the compensation that state law assures them."⁴⁵³

The dissenters also cited no authority here, but might perhaps be excused for foregoing an attempt to establish a negative.

Among other cases we might consider here is *Hinderlider v. LaPlata River Cherry Creek Ditch Co.*,⁴⁵⁴ a decision handed down the same day as the decision in *Erie*. The Court reaffirmed, in sum, that the grant of jurisdiction over controversies concerning rights in interstate streams *required* them to seek a certain rule of decision in "federal common law."⁴⁵⁵

⁴⁵¹ *Id.* at 504 (emphasis added) (citations omitted).

⁴⁵² *Boyle*, 487 U.S. at 515-32 (Brennan, J., dissenting).

⁴⁵³ *Id.* at 515-16 (Brennan, J., dissenting).

⁴⁵⁴ 304 U.S. 92 (1938). See *supra* note 74 and accompanying text; see also reports styled "State A v. State B."

⁴⁵⁵ *LaPlata River Ditch Co.*, 304 U.S. at 110.

3. Rule of Decision Suggested by Act(s) of Congress

Here, the sampling problem rued earlier becomes acute.⁴⁵⁶ Exhaustive checking would generate a compendium to the United States Code. Instead, I rest content, for the time being, with sampling the cases cited by courts and commentators. The subpart begins with cases in which the Court itself relied solely upon broad allusions to federal legislation. It proceeds to cases in which opinions cited acts, or parts of acts, more or less specifically. In some of the cases canvassed, decisions held cited statutory sources to *require* a federal rule of decision. In others, they did not.

a. "Various Acts of Congress"

In *Guaranty Trust Co. v. York*,⁴⁵⁷ a note-holding beneficiary under an investment trust sued Guaranty Trust, the trustee, in United States District Court for the Southern District of New York, on behalf of herself and other noteholders similarly situated, for breach of fiduciary duty and for an accounting.⁴⁵⁸ The district court rendered summary judgment for Guaranty Trust "on the ground that the action was barred by limitations or laches."⁴⁵⁹ The court of appeals reversed.⁴⁶⁰ On certiorari, the question deemed presented was "whether, when no recovery could be had in a State court because the action is barred by the statute of limitations, a federal court in equity can take cognizance of the suit because there is diversity of citizenship between the parties."⁴⁶¹ Reversing the court of appeals, the majority held no.⁴⁶² Said Justice Frankfurter, "Our starting point must be the policy of federal jurisdiction

⁴⁵⁶ See *supra* pp. 191-92.

⁴⁵⁷ 326 U.S. 99 (1945).

⁴⁵⁸ *Guaranty Trust*, 326 U.S. at 100.

⁴⁵⁹ *York v. Guaranty Trust Co.*, 143 F.2d 503, 528 (2d Cir. 1944).

⁴⁶⁰ *Guaranty Trust*, 326 U.S. at 100-01.

⁴⁶¹ *Id.* at 107. Shortly after deciding *Erie*, the Justices had said: "The [*Erie*] doctrine applies though the question of construction arises not in an action at law, but in a suit in equity." *Ruhlin v. New York Life Ins. Co.*, 304 U.S. 202, 205 (1938).

⁴⁶² *Guaranty Trust*, 326 U.S. at 112.

which *Erie R. Co. v. Tompkins* embodies," which touches vitally the proper distribution of judicial power between state and federal courts.⁴⁶³ "Our starting point must be" *Erie*, not the Rules of Decision Act? Rather than consecrating the twin aims of *Erie*, Justice Frankfurter might have seen *Erie's* legitimate concerns originating in constitutional principle and addressed by the Act itself. What was, or is, wrong with the policy and vision embodied, whether by design or happy accident, by the Act's own words?

Justice Frankfurter could have justified his desired result as a conscious civilian. Being so disposed, he would have found nothing in the United States Constitution, a treaty of the United States, an act of Congress, or a rule adopted by and within the authority of a valid act of Congress *providing* or *requiring* a federal period of limitation for this breach of trust action. On the other hand, he would have found the Tenth Amendment, a text requiring "the proper distribution of judicial power between State and federal courts."⁴⁶⁴ He would then have looked to the laws of the several states, in cases where they apply, which, in this case, were the laws of the state providing the action for breach of trust.

In his dissent, however, Justice Rutledge found federally enacted texts *requiring* a different rule of decision, that is, a limitation period measured by established federal equity practice.⁴⁶⁵ As he said:

If any characteristic of equity jurisprudence has descended unbroken from and within "the traditional scope of equity as historically evolved in the English Court of Chancery," it is that statutes of limitations, often in terms applying only to actions at law, have never been deemed to be rigidly applicable as absolute barriers to suits in equity as they are to actions at law. *That tradition, it would seem, should be regarded as having been incorporated in the various Acts of Congress which have conferred equity jurisdiction upon the federal*

⁴⁶³ *Id.* at 101 (citation omitted).

⁴⁶⁴ *Id.* at 109.

⁴⁶⁵ *Id.* at 112-19 (Rutledge, J., dissenting).

courts. . . . It is now excised from those Acts. If there is to be excision, Congress, not this Court, should make it.⁴⁶⁶

Justice Frankfurter might have directed his policy argument against the contention that certain acts of Congress *required* Justice Rutledge's proffered rule of decision. Had he conceded Justice Rutledge's conclusion, however, his policy argument would have been beside the point.

Some have suggested that Justice Frankfurter went well beyond *Erie*, when he said:

In essence, the intent of [*Erie*] was to insure that, in all cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties, the outcome of the litigation in the federal court should be substantially the same, so far as legal rules determine the outcome of a litigation, as it would be if tried in a State court. The nub of the policy that underlies *Erie R. Co. v. Tompkins* is that for the same transaction the accident of a suit by a non-resident litigant in a federal court instead of in a State court a block away should not lead to a substantially different result.⁴⁶⁷

And indeed, in august contemplation of *York's* "outcome determinative" test, the shades of the Founding Fathers may well have murmured, "That is not what [we] meant, at all."⁴⁶⁸

I am not historian enough to insist presently upon the sustainability of this proposition, but my reading of the Rules of Decision Act itself and the early opinions applying or ignoring it leads me to conjecture that the interstate creditors, in whose service the Founding Fathers acted, certainly did hope for outcomes in federal courts different from the outcomes they feared in state courts.⁴⁶⁹ Without that possibility, even if not

⁴⁶⁶ *Id.* at 114 (Rutledge, J., dissenting) (emphasis added).

⁴⁶⁷ *Id.* at 109.

⁴⁶⁸ T.S. ELIOT, *THE LOVE SONG OF J. ALFRED PRUFROCK*.

⁴⁶⁹ Some historians have seen such evidence, too. See BRIDWELL & WHITTEN, *supra* note 24, at 90-91:

[I]n choosing the place of trial he (or his attorney) doubtless selected the federal court in the hope that its judgment on the general commercial law point would be more favorable than the opinion of the New York

that certainty, diversity jurisdiction for originating courts made, and still makes, scarcely any sense at all. Justice Frankfurter thought he had smothered this suggestion by saying that, in responding to creditors' fears of "local bias in State courts, . . . Congress afforded out-of-State litigants another tribunal, not another body of law."⁴⁷⁰ This was fancy footwork indeed. But, as Justice Rutledge and other critics might have responded, the concern of interstate creditors about "local bias" might well have encompassed a more sophisticated concern that "the equity" of the Commerce Clause and the Contracts Clause not be forgotten in the feverish solicitude of local courts for local debtors. The promise of the United States Supreme Court's eventual protection, on appeal, from forgetful state court decisions would have offered scant comfort. Even successful trial court litigation can swallow the profits anticipated from commercial transactions. How often can a reasonable economic actor afford the iffy vindication of superimposed appellate proceedings?

An earlier case like *York* was *Cities Service Oil Co. v. Dunlap*.⁴⁷¹ Cities Service sued Dunlap in the United States District Court for the Eastern District of Texas to remove a cloud from its title to a certain mineral lease.⁴⁷² At trial, Cities Service argued that, according to Texas caselaw, Dunlap had to prove that Cities Service was not a bona fide purchaser for value of the lease.⁴⁷³ The district court acknowledged the Texas rule, but held that, under the better rule in equity, Cities Service had to prove that it was a bona fide purchaser for

courts. This kind of "forum shopping" was exactly what the diversity jurisdiction was designed to accomplish.

See also *id.* at 130-31; FREYER, *supra* note 24, at 79; Henry J. Friendly, *The Historic Basis of Diversity Jurisdiction*, 41 HARV. L. REV. 483 (1928). But see, e.g., Hessel E. Yntema & George H. Jaffin, *Preliminary Analysis of Concurrent Jurisdiction*, 79 U. PA. L. REV. 869 (1931).

⁴⁷⁰ *Guaranty Trust*, 326 U.S. at 111-12.

⁴⁷¹ 308 U.S. 208 (1939).

⁴⁷² *Cities Serv.*, 308 U.S. at 210.

⁴⁷³ *Id.*

value.⁴⁷⁴ The district court rendered judgment for Dunlap.⁴⁷⁵ The United States Court of Appeals for the Fifth Circuit affirmed.⁴⁷⁶ On certiorari, the Supreme Court reversed.⁴⁷⁷ The opinion did not cite the Rules of Decision Act. A citation to *Erie* appeared only in a quotation from the court below.⁴⁷⁸ Although it did not, *provide-or-require* analysis might have proceeded the way it could have some years later in *York*, with the opinion looking for and finding nothing in the Constitution, treaties, or statutes of the United States *providing* or *requiring* the rule of decision applied by the district court. A dissenter might have argued, as Justice Rutledge did in *York*, that the district court's preferred rule of decision concerning the burdens of proof was a "characteristic of equity jurisprudence" that had "descended unbroken from and within 'the traditional scope of equity as historically evolved in the English Court of Chancery.'"⁴⁷⁹ That is, federal statutory sources arguably *required* the rule of decision identified by the district court.

*Wilson v. Omaha Indian Tribe*⁴⁸⁰ arguably fits most comfortably in this category as well. Although the majority of the Supreme Court did not invoke "various acts of Congress," it held that federal law *required* definitions of "accretion" and "avulsion" where the United States and an Indian tribe asserted claims to allegedly tribal land.⁴⁸¹ They went on, however, to adopt as federal law the definitions provided by Nebraska law.⁴⁸²

⁴⁷⁴ *Id.* at 211.

⁴⁷⁵ *Id.* at 210.

⁴⁷⁶ *Id.*

⁴⁷⁷ *Cities Serv.*, 308 U.S. at 212-13.

⁴⁷⁸ *Id.* at 212.

⁴⁷⁹ *Guaranty Trust*, 326 U.S. at 114.

⁴⁸⁰ 442 U.S. 653 (1979).

⁴⁸¹ *Wilson*, 442 U.S. at 678-79.

⁴⁸² *Id.*

*b. Specific Acts or Parts of Acts Other Than the Rules
Enabling Act*⁴⁸³

*1) The United States Arbitration Act of 1925*⁴⁸⁴

In *Bernhardt v. Polygraphic Co. of America, Inc.*,⁴⁸⁵ the Justices' attention fell upon the United States Arbitration Act.⁴⁸⁶ In a Vermont state court, Bernhardt commenced this action to recover damages for his dismissal allegedly contrary to the terms of a written employment contract.⁴⁸⁷ Polygraphic Company removed the action to the United States District Court for the District of Vermont and then moved for a stay of proceedings pending arbitration, as provided by a term of the contract.⁴⁸⁸ The district court denied the stay.⁴⁸⁹ The United States Court of Appeals for the Second Circuit reversed.⁴⁹⁰ On certiorari, the Justices reversed and remanded to the district court to determine whether Vermont law applied Vermont law or New York law to questions raised by the arbitration clause.⁴⁹¹ The United States Arbitration Act of 1925 did not, began Justice Douglas, control this arbitration agreement and, therefore, neither did the Act's procedural provision for a stay pending arbitration.⁴⁹² Apparently, no other controlling provision of federal law occurred to counsel or to the Court either. Therefore, their opinion could continue, "[t]he question remains whether, apart from the Federal Act, a provision of a contract providing for arbitration is enforceable in a diversity case."⁴⁹³ The opinion concluded that the answer depended upon Ver-

⁴⁸³ 28 U.S.C. § 2072 (1994).

⁴⁸⁴ 9 U.S.C. §§ 1-14 (1970).

⁴⁸⁵ 350 U.S. 198 (1956).

⁴⁸⁶ *Bernhardt*, 350 U.S. at 199. See *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967) (holding that claims of fraud were province of arbitrators under arbitration clause of contract and Arbitration Act).

⁴⁸⁷ *Id.*

⁴⁸⁸ *Id.*

⁴⁸⁹ *Id.*

⁴⁹⁰ *Id.*

⁴⁹¹ *Bernhardt*, 350 U.S. at 205.

⁴⁹² *Id.* at 200-01.

⁴⁹³ *Id.* at 202.

mont state law.⁴⁹⁴ Under *provide-or-require* analysis, this conclusion would have required no expatiation. Absent a trumping federal rule of decision, state law applies, period. No need exists to rhapsodize about federalism or outcome determination. The First Congress, whether in its wisdom or all unawares, had already taken care of that, and at a time when federation was more freshly in mind than today. Nevertheless, the opinion rhapsodized:

[i]f the federal court allows arbitration where the state court would disallow it, the outcome of litigation might depend on the court-house where suit is brought. For the remedy by arbitration, whatever its merits or shortcomings, substantially affects the cause of action created by the State. The nature of the tribunal where suits are tried is an important part of the parcel of rights behind a cause of action. The change from a court of law to an arbitration panel may make a radical difference in ultimate result. . . . "The nub of the policy that underlies *Erie R. Co. v. Tompkins* is that for the same transaction the accident of a suit by a non-resident litigant in a federal court instead of in a state court a block away should not lead to a substantially different result." . . . There would in our judgment be a *resultant discrimination* if the parties suing on a Vermont cause of action in the federal court were remitted to arbitration, while those suing in the Vermont court could not be.⁴⁹⁵

None of the opinions cited section 1652.

Subsequent events arguably dramatize what the Founding Fathers might have had in mind. During the thirty-eight years in which the United States Arbitration Act was thought to bind only federal courts, no states' rights outcry arose.⁴⁹⁶ But after the Supreme Court held the Act binding upon state courts as well,⁴⁹⁷ twenty state attorneys general appeared to urge them

⁴⁹⁴ *Id.* at 205.

⁴⁹⁵ *Id.* at 203-04 (emphasis added).

⁴⁹⁶ At least, research has so far revealed none.

⁴⁹⁷ See *Southland Corp. v. Keating*, 465 U.S. 1, 16 (1984) (finding provision of state law requiring judicial considerations of claims preempted by Arbitration Act).

to change its mind.⁴⁹⁸ As the shades of the Founding Fathers might put it, providing an alternative court that enforces distasteful law offends states' rights (now federalist) sensibilities less violently than imposing that distasteful law on the states' own courts. The suspicion that this view might have had adherents among the Founding Fathers' contemporaries finds support in our understanding that "the Court consistently refused to entertain appeals from the state courts when those courts rendered decisions that conflicted with the Supreme Court's [pre-*Erie*] general law pronouncements."⁴⁹⁹ It finds expression also in the words of 20th-century thinkers. For example, Professor Corbin said:

The very reason for which jurisdiction was given to the federal courts in diversity of citizenship cases was that it was contemplated that such a difference [with a state court in its determination of the legal operation of specific facts in the litigated case] ought sometimes to exist.⁵⁰⁰

Note also the words of United States Circuit Judge Samuel H. Sibley: "[T]here are occasions when the very purpose of the grant of federal jurisdiction is to obtain a different result from that likely to be reached in a state court."⁵⁰¹

2) *The Labor Management Relations Act of 1947,*
*Section 103*⁵⁰²

In *Textile Workers Union of America v. Lincoln Mills*,⁵⁰³ the majority invoked neither section 1652 nor *provide-or-require* reasoning by name, but nevertheless rendered the most breath-taking *provide-or-require* decision since *Watson v. Tarpley*.⁵⁰⁴ The Union had sued Lincoln Mills in United

⁴⁹⁸ See *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 272 (1995) (finding Arbitration Act's reach broad because of federal Commerce Clause powers).

⁴⁹⁹ TEPLY & WHITTEN, *supra* note 7, at 405.

⁵⁰⁰ Corbin, *supra* note 5, at 776 n.17.

⁵⁰¹ Sibley, *supra* note 5, at 173.

⁵⁰² 29 U.S.C. § 185 (1998).

⁵⁰³ 353 U.S. 448 (1957).

⁵⁰⁴ 59 U.S. (18 How.) 517 (1855).

States District Court for the Northern District of Alabama to compel arbitration under a collective bargaining agreement of grievances concerning work loads and work assignments.⁵⁰⁵ The district court had asserted subject matter jurisdiction and ordered Lincoln Mills to submit the grievances to arbitration.⁵⁰⁶ The United States Court of Appeals for the Fifth Circuit reversed, holding that the district court "had no authority founded either in federal or state law to grant the relief."⁵⁰⁷ On writ of certiorari, the Supreme Court reversed, holding that 28 U.S.C. section 185 (section 301 of the Labor Management Relations Act of 1947), which *provided* nothing more than federal subject matter jurisdiction over interstate labor-management disputes, *required* a rule of decision supporting the district court's disposition of the suit.⁵⁰⁸ Justice Douglas began, "[T]he substantive law to apply in suits under section 301(a) is federal law, which the courts must fashion from the policy of *our national labor laws*."⁵⁰⁹ He continued:

Federal interpretation of the federal law will govern, not state law. . . . But state law, if compatible with the purpose of section 301, may be resorted to in order to find the rule that will best effectuate the federal policy. . . . Any state law applied, however, will be absorbed as federal law and will not be an independent source of private rights.⁵¹⁰

In dissent, Justice Frankfurter argued that Congress had no constitutional authority to enact the purported grant of subject matter jurisdiction embodied by section 301(a).⁵¹¹

In *DelCostello v. International Bhd. of Teamsters*,⁵¹² the majority again held that section 301 *required* (although it certainly did not *provide*) a federal rule of decision, this time the

⁵⁰⁵ *Lincoln Mills*, 353 U.S. at 449.

⁵⁰⁶ *Id.*

⁵⁰⁷ *Id.* at 449.

⁵⁰⁸ *Id.* at 456-57.

⁵⁰⁹ *Id.* at 456 (emphasis added).

⁵¹⁰ *Lincoln Mills*, 353 U.S. at 457.

⁵¹¹ *Id.* at 461-84 (Frankfurter, J., dissenting).

⁵¹² 462 U.S. 151 (1983).

statute of limitation for labor-management suits in federal court.⁵¹³ The majority opinion said:

[29 U.S.C. section 160(b) (National Labor Relations Act)] should be the applicable statute of limitations governing the suit, both against the employer [for breach of a collective bargaining agreement] and against the union [for breach of the duty of fair representation in an arbitration proceeding].⁵¹⁴

There is, it said,

no federal statute of limitations expressly applicable to this suit. In such situations we . . . have generally concluded that Congress intended that the courts apply the most closely analogous statute of limitations under state law.⁵¹⁵

But then it reversed its field, saying, "In some circumstances, however, state statutes of limitations can be unsatisfactory vehicles for the enforcement of federal law."⁵¹⁶ Going on to explain, it said:

[S]tate arbitration statutes typically provide very short times in which to sue for vacation of arbitration awards. . . . [S]tate limitations periods for vacating arbitration awards fail to provide an aggrieved employee with a satisfactory opportunity to vindicate his rights under section 301 and the fair representation doctrine.⁵¹⁷

Justice Stevens dissented, arguing that section 1652 *required* federal courts to apply the most closely analogous state statute of limitation.⁵¹⁸ He twice invoked by name section 1652's "require or provide" formula, arguing that nothing in federally enacted texts *provided* a rule of decision or *required* the majori-

⁵¹³ *DelCostello*, 462 U.S. at 173-74 n.1 (Stevens, J., dissenting).

⁵¹⁴ *Id.* at 155.

⁵¹⁵ *Id.* at 158.

⁵¹⁶ *Id.* at 161.

⁵¹⁷ *Id.* at 166.

⁵¹⁸ *DelCostello*, 462 U.S. at 173-74 n.1 (Stevens, J., dissenting).

ty to displace the applicable state rule of decision.⁵¹⁹

On the other hand, in *International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW) v. Hoosier Cardinal Corp.*,⁵²⁰ a majority of the Court found that section 301 did not *require* a uniform federal statute of limitation.⁵²¹ The Union commenced this action against the Company in United States District Court for the Southern District of Indiana to recover payment for vacation time allegedly due under a collective bargaining agreement.⁵²² The district court dismissed the action as barred by Indiana's six-year statute of limitation governing contracts not in writing.⁵²³ The United States Court of Appeals for the Seventh Circuit affirmed.⁵²⁴ On writ of certiorari, six of nine Justices affirmed, saying: "[S]tate statutes have repeatedly supplied the periods of limitations for federal causes of action when federal legislation has been silent on the question."⁵²⁵ Their opinion concluded: "Section 301 of the Labor Management Relations Act establishes no such policy of uniformity [as does the FELA limitations provision] expressed in a national limitations provision."⁵²⁶

3) *The Sherman Anti-Trust Act*⁵²⁷

*Sola Electric Co. v. Jefferson Electric Co.*⁵²⁸ held, in effect, if not in so many words, that the Sherman Act *required* the ap-

⁵¹⁹ *Id.* at 172-74.

⁵²⁰ 383 U.S. 696 (1966).

⁵²¹ *Hoosier Cardinal*, 383 U.S. at 702 (Rules of Decision Act cited by dissenters White, Douglas, and Brennan).

⁵²² *Id.* at 699.

⁵²³ *Id.*

⁵²⁴ *Id.*

⁵²⁵ *Id.* at 704.

⁵²⁶ *Hoosier Cardinal*, 383 U.S. at 708. For other opinions wrestling with the question whether to "borrow" a statute of limitation from state law or federal law, but written in cases implicating different federally enacted texts, see, e.g., *Lampf v. Gilbertson*, 501 U.S. 350 (1991); *Reed v. United Transp. Union*, 488 U.S. 319 (1989); *Agency Holding Corp. v. Malley-Duff & Assoc., Inc.*, 483 U.S. 143 (1987).

⁵²⁷ 15 U.S.C. §§ 1-7 (1997).

⁵²⁸ 317 U.S. 173 (1942).

plication of a federal rule of decision about estoppel rather than the forum state's rule.⁵²⁹ Jefferson, a patent licensor, commenced the action against Sola Electric, its patent licensee, in the United States District Court for the Northern District of Illinois to recover unpaid royalties and obtain an injunction "restraining further sales except in conformity to the terms of the license agreement."⁵³⁰ One of the terms made fixed prices illegal under the Sherman Act, unless within a valid patent monopoly.⁵³¹ Sola counterclaimed for a declaration that Jefferson's patent was partially invalid.⁵³² The district court dismissed Sola Electric's counterclaim, holding Sola Electric estopped, as a licensee, from asserting the patent's invalidity.⁵³³ The United States Court of Appeals for the Seventh Circuit affirmed.⁵³⁴ On writ of certiorari, the Supreme Court reversed. Wrote Justice Strong:

[T]he prohibition of a federal statute may not be set at naught, or its benefits denied, by state statutes or state common law rules. In such a case our decision is not controlled by [*Erie*]. . . . [L]ocal rules of estoppel will not be permitted to thwart the purposes of statutes of the United States.⁵³⁵

Directing that "[Sola Electric] may assert the illegality of the price-fixing agreement and may offer any competent evidence to establish its illegality, including proof of the invalidity of the patent,"⁵³⁶ the opinion concluded, "[l]ocal rules of estoppel which would fasten upon the public as well as the petitioner the burden of an agreement in violation of the Sherman Act must yield to the Act's declaration that such agreements are unlawful"⁵³⁷ In other words, the Sherman Act *required* a

⁵²⁹ *Sola Elec.*, 317 U.S. at 177.

⁵³⁰ *Id.* at 173-74.

⁵³¹ *Id.* at 174-75.

⁵³² *Id.* at 175.

⁵³³ *Id.* at 174.

⁵³⁴ *Sola Elec.*, 317 U.S. at 174.

⁵³⁵ *Id.* at 176.

⁵³⁶ *Id.* at 177.

⁵³⁷ *Id.*

rule of decision consonant with its purposes.

4) *The Aid to Small Business Act, Section 7(a)*⁵³⁸

The holding in *United States v. Kimbell Foods, Inc.*⁵³⁹ confirms a proposition suggested earlier. That is, the rule of decision *required* by an act of Congress need not necessarily be a rule drawn from federal law.⁵⁴⁰ Kimbell Foods commenced this suit against the United States in United States District Court for the Northern District of Texas to foreclose the lien of a security interest perfected under Texas state law.⁵⁴¹ Asserting a lien securing a loan guaranteed by the Small Business Administration under section 7(a) of the Small Business Act, the United States argued that Kimbell's state lien, although prior in time and effective as to the credit already extended at the time of perfection, did not cover credit extended after the perfection of the federal lien.⁵⁴² As to this credit, the state lien was, according to the United States, "inchoate" under the controlling federal rule of decision.⁵⁴³ The district court ruled for the United States.⁵⁴⁴ The United States Court of Appeals for the Fifth Circuit reversed.⁵⁴⁵ It did not, however, "adopt Texas law[, but] proceeded to decide whether the future advances should receive the same treatment under federal common law."⁵⁴⁶ On writ of certiorari, the Supreme Court vacated and remanded for determination of questions raised by its decision and opinion.⁵⁴⁷ Saying, "[f]ederal law governs questions involving the rights of the United States arising under nationwide federal programs,"⁵⁴⁸ Justice Marshall then elabo-

⁵³⁸ 15 U.S.C. § 636(A)(1) (1997).

⁵³⁹ 440 U.S. 715 (1979).

⁵⁴⁰ See *supra* note 39 and accompanying text.

⁵⁴¹ *Kimbell Foods*, 440 U.S. at 720.

⁵⁴² *Id.*

⁵⁴³ *Id.* at 722.

⁵⁴⁴ *Id.* at 720.

⁵⁴⁵ *Id.* at 722.

⁵⁴⁶ *Kimbell Foods*, 440 U.S. at 722-23.

⁵⁴⁷ *Id.* at 740.

⁵⁴⁸ *Id.* at 726 (emphasis added).

rated:

[T]he priority of liens stemming from federal lending programs must be determined with reference to federal law. The SBA and FHA unquestionably perform federal functions within the meaning of *Clearfield*. Since the agencies derive their authority to effectuate loan transactions from specific Acts of Congress passed in the exercise of a "constitutional function or power," . . . their rights, as well, should derive from a federal source. When Government activities "aris[e] from and bea[r] heavily upon a federal . . . program," the Constitution and Acts of Congress "require otherwise than that state law govern of its own force."⁵⁴⁹

In language bearing transparently on the distinction between *provide* and *require*, the opinion said:

That the statutes authorizing these federal lending programs do not specify [i.e., *provide*] the appropriate *rule of decision* in no way limits the reach of federal law. It is precisely when Congress has not spoken "in an area comprising issues substantially related to an established program of government operation," . . . that *Clearfield* [i.e., section 1652] directs [i.e., *requires*] federal courts to *fill the interstices* of federal legislation "according to their own standards."⁵⁵⁰

Returning then to the proposition that the rule of decision *required* by federal law may be drawn from state law, the opinion went on:

Controversies directly affecting the operations of federal programs, although governed by federal law, do not inevitably *require* resort to uniform federal rules. . . . Whether to adopt state law or to fashion a nationwide federal rule is a matter of judicial policy "dependent upon a variety of considerations always relevant to the nature of the specific governmental interests and to the effects upon them of applying state law."⁵⁵¹

⁵⁴⁹ *Id.* at 726-27 (emphasis added).

⁵⁵⁰ *Id.* at 727 (emphasis added).

⁵⁵¹ *Kimbell Foods*, 440 U.S. at 727-28 (emphasis added).

It elaborated the nature of the choice as follows:

Undoubtedly, federal programs that "by their nature are and must be uniform in character throughout the Nation" necessitate formulation of controlling federal rules. . . . Conversely, when there is little need for a nationally uniform body of law, state law may be incorporated as the federal *rule of decision*. Apart from considerations of uniformity, we must also determine whether application of state law would frustrate specific objectives of the federal programs. . . . Finally, our choice-of-law inquiry must consider the extent to which application of a federal rule would disrupt commercial relationships predicated upon state law.⁵⁵²

Explaining that "[i]ncorporating state law to determine the rights of the United States as against private creditors would in no way hinder administration of the SBA and FHA loan programs[,]">⁵⁵³ the opinion continued, "[b]ecause the state commercial codes "furnish convenient solutions in no way inconsistent with adequate protection of the federal interest[s]," . . . we decline to override intricate *state laws* of general applicability on which private creditors base their daily commercial transactions."⁵⁵⁴

It concluded:

In structuring financial transactions, businessmen depend on state commercial law to provide the stability essential for reliable evaluation of the risks involved. . . . However, subjecting federal contractual liens to the doctrines developed in the tax lien area could undermine that stability. Creditors who justifiably rely on state law to obtain superior liens would have their expectations thwarted whenever a federal contractual security interest suddenly appeared and took precedence.⁵⁵⁵

⁵⁵² *Id.* at 728-29 (emphasis added).

⁵⁵³ *Id.* at 729.

⁵⁵⁴ *Id.* (emphasis added).

⁵⁵⁵ *Id.* at 739 (emphasis added).

The opinion did not cite section 1652.

5) *The Copyright Act of 1947, Section 24*⁵⁵⁶

In *De Sylva v. Ballentine*⁵⁵⁷ the majority held that the word "children" in section 24 of the Copyright Act of 1947 included an illegitimate child in an action controlled by California law, saying, "[t]he scope of a federal right is, of course, a federal question, but that does not mean that its content is not to be determined by state, rather than federal law. . . . [T]here is no federal law of domestic relations, which is primarily a matter of state concern."⁵⁵⁸ Pursuing this reasoning, it said:

To decide who is the widow or widower of a deceased author, or who are his executors or next of kin, requires a reference to the law of the State which created those legal relationships. The word "children," although it to some extent describes a purely physical relationship, also describes a legal status not unlike the others. To determine whether a child has been legally adopted, for example, requires a reference to state law.⁵⁵⁹

The opinion concluded:

We think it proper, therefore, to draw on the ready-made body of state law to define the word "children" in section 24. This does not mean that a State would be entitled to use the word "children" in a way entirely strange to those familiar with its ordinary usage, but at least to the extent that there are permissible variations in the ordinary concept of "children" we deem state law controlling.⁵⁶⁰

Justices Douglas and Black would have *required* a uniform federal definition for "children" as used in the Copyright Act.⁵⁶¹ Neither opinion cited section 1652, although the dis-

⁵⁵⁶ 17 U.S.C. § 203(a)(2) (1996).

⁵⁵⁷ 351 U.S. 570 (1956).

⁵⁵⁸ *DeSylva*, 351 U.S. at 580.

⁵⁵⁹ *Id.*

⁵⁶⁰ *Id.* at 580-81.

⁵⁶¹ *Id.* at 583 (Douglas, J., dissenting).

sent did contain the reminiscent words, "the laws of the several States."⁵⁶²

6) *The Investment Company Act of 1940*⁵⁶³

In *Kamen v. Kemper Financial Services, Inc.*,⁵⁶⁴ the plaintiff commenced her stockholders' derivative suit in the United States District Court for the Northern District of Illinois on behalf of the Cash Equivalent Fund, Inc. ("the Fund"), against Kemper Financial Services, the Fund's investment advisor.⁵⁶⁵ In her complaint, she alleged "that she made no precomplaint demand on the Fund's board of directors because doing so would have been futile."⁵⁶⁶ Upon Kemper's motion, the district court dismissed Kamen's suit "on the ground that [she] had failed to plead the facts excusing demand with sufficient particularity for purposes of Federal Rule of Civil Procedure 23.1."⁵⁶⁷ The Seventh Circuit Court of Appeals affirmed the dismissal, but on a more ambitious ground.⁵⁶⁸ "[A]dopt[ing] as a rule of federal common law the ALI's so-called 'universal demand' rule, under which the futility exception [to the demand requirement] is abolished," the Court of Appeals held Kamen's conceded "failure to make a precomplaint demand . . . fatal to her case."⁵⁶⁹ Granting a writ of certiorari, the Supreme Court reversed, first addressing the role and scope of Federal Rule 23.1⁵⁷⁰ and then holding that the lower courts should have looked to the law of the state of Maryland, the state of the Fund's incorporation.⁵⁷¹ Justice Marshall wrote:

[T]he contours of the demand requirement in a derivative

⁵⁶² *Id.*

⁵⁶³ 15 U.S.C. §§ 80a-1 et seq. (1997).

⁵⁶⁴ 500 U.S. 90 (1991).

⁵⁶⁵ *Kamen*, 500 U.S. at 93-94.

⁵⁶⁶ *Id.* at 94.

⁵⁶⁷ *Id.*

⁵⁶⁸ *Id.*

⁵⁶⁹ *Id.*

⁵⁷⁰ *See infra* pp. 315-17.

⁵⁷¹ *Kamen*, 500 U.S. at 108-09.

action founded on the ICA [Investment Company Act of 1940] are governed by *federal* law. Because the ICA is a federal statute, any common law rule necessary to effectuate a private cause of action under that statute is necessarily federal in character. . . . [A] court should endeavor to *fill the interstices of federal remedial schemes* with uniform federal rules only when the scheme in question evidences a distinct need for nationwide legal standards. . . . Otherwise, . . . federal courts should "incorporat[e] [state law] as the federal rule of decision," unless "application of [the particular] state law [in question] would frustrate specific objectives of the federal programs."⁵⁷²

That is, although an act of Congress controlled, it did not *require* a federally fashioned rule of decision which it had not (but could have) *provided*. As the opinion made clear, other acts of Congress might *require* federally fashioned rules "to fill the interstices" which one finds, either by design or unavoidably, in virtually every statute. This one, however, did not. The opinion did not cite section 1652.

In *Burks v. Lasker*,⁵⁷³ Lasker and other shareholders of Fundamental Investors, Inc., commenced their derivative suit against Burks and other members of Fundamental's board of directors in United States District Court for the Southern District of New York, alleging violation of duties under the Investment Company Act (ICA) and the Investment Advisers Act (IAA).⁵⁷⁴ Fundamental's outside directors, acting as a quorum, decided against continuing the suit.⁵⁷⁵ On their motion, the district court rendered summary judgment against the plaintiffs.⁵⁷⁶ The Court of Appeals for the Second Circuit reversed, holding that the ICA controlled, not state law, and under the ICA, the outside directors could not foreclose the shareholders' suit.⁵⁷⁷ On certiorari, the Supreme Court reversed, holding

⁵⁷² *Id.* at 97-98 (emphasis of "federal" in original; other emphasis added).

⁵⁷³ 441 U.S. 471 (1979).

⁵⁷⁴ *Lasker*, 441 U.S. at 473.

⁵⁷⁵ *Id.* at 474.

⁵⁷⁶ *Id.* at 475.

⁵⁷⁷ *Id.*

"that federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the ICA and IAA."⁵⁷⁸ "[W]e shall assume without deciding," said Justice Brennan, "that respondents have implied, derivative causes of action under the ICA and IAA. . . . [Therefore,] it is clear that our decision is not controlled by [*Erie*] . . . and state law does not operate of its own force."⁵⁷⁹ Addressing the question of when an act of Congress might *require* a rule of decision it did not *provide*, Justice Brennan said, "[l]egal rules which impact significantly upon the effectuation of federal rights must, therefore, be treated as raising federal questions."⁵⁸⁰ In certain areas, he continued, "federal statutes authorize the federal courts to fashion a complete body of federal law. . . . Corporation law, however, is not such an area."⁵⁸¹ Pressing on, he said, "[t]he first place one must look to determine the powers of corporate directors is in the relevant State's corporation law. . . . [I]n this field congressional legislation is generally enacted against the background of existing state law; . . . "⁵⁸² He concluded:

The ICA and IAA, therefore, do not *require* that federal law displace state laws governing the powers of directors unless the state laws permit actions prohibited by the Acts, or unless "their application would be inconsistent with the federal policy underlying the cause of action"⁵⁸³

That is, an act of Congress might or might not *require* a rule of decision it did not *provide*. None of the three opinions cited section 1652.

⁵⁷⁸ *Id.* at 486.

⁵⁷⁹ *Lasker*, 441 U.S. at 476.

⁵⁸⁰ *Id.* at 477.

⁵⁸¹ *Id.*

⁵⁸² *Id.* at 478.

⁵⁸³ *Id.* at 479 (emphasis added).

7) 28 U.S.C. § 132(a)⁵⁸⁴

Title 28, section 132(a), provides: "There shall be in each judicial district a district court which shall be a court of record known as the United States District Court for the district."⁵⁸⁵

In *Chambers v. NASCO, Inc.*,⁵⁸⁶ the Supreme Court upheld, 5-4, the district court's imposition upon Chambers of NASCO's attorney fees and attorney-borne expenses in full, \$996,644.65, for many instances of bad faith conduct perpetrated throughout the course of the litigation and obviously intended to frustrate and thwart the court's authority. For parts of the award, the district court might have invoked one or another of the Federal Rules of Civil Procedure, principally perhaps Rule 11, as well as provisions of several federal statutes. For other parts, the district court deemed those sources of authority inadequate or inapplicable. To have sorted it all out part by part and source by source would have "serve[d] only to foster extensive and needless satellite litigation, which is contrary to the aim of the Rules themselves."⁵⁸⁷ Consequently, the district court invoked its inherent power to support the entire award. The majority approved this. While saying, "[i]t may be that the District Court could have imposed the full million dollar sanction against petitioner through reliance on Federal Rules and statutes, as well as on a proper exercise of its inherent authority,"⁵⁸⁸ three dissenters insisted the district court should have invoked its inherent authority only after a full accounting and as a last resort. None of the three opinions invoked *provide-or-require* thinking by name, but all three could have. Following section 1652 leads to 28 U.S.C. section 132(a), which creates the district courts. As all three opinions agreed, a statute creating a court *requires*, by the very definition of what a court is, the implication of certain unspoken or "inherent" powers to vindicate its authority as a court. The

⁵⁸⁴ 28 U.S.C. § 132(a) (1993).

⁵⁸⁵ *Id.*

⁵⁸⁶ 501 U.S. 32 (1991).

⁵⁸⁷ *Chambers*, 501 U.S. at 51.

⁵⁸⁸ *Id.* at 76.

"inherent power" invoked in *Chambers* was such a power.

8) 28 U.S.C. § 1404(a) (*Change of Venue*)⁵⁸⁹

Section 1404(a) provides: "For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought."⁵⁹⁰ The following text considers three decisions in which the Court has read section 1404(a) with *Erie* doctrine.

First, let us consider *Van Dusen v. Barrack*.⁵⁹¹ Acting as an administratrix and commencing her action in United States District Court for the Eastern District of Pennsylvania, Barrack sued Eastern Airlines for the wrongful death of her decedent in an airplane crash in Boston Harbor. Barrack had qualified to act as administratrix under Pennsylvania law, but not under Massachusetts law. Upon the motion of Eastern Airlines, and acting under 28 U.S.C. section 1404(a), District Judge Van Dusen ordered the action transferred to the United States District Court for the District of Massachusetts. Upon Barrack's petition, the United States Court of Appeals for the Third Circuit issued a writ of mandamus to vacate the order of transfer, saying that "a section 1404(a) transfer could be granted only if at the time the suits were brought, the plaintiffs had qualified to sue in Massachusetts, the State of the transferee District Court."⁵⁹² On writ of certiorari, the Supreme Court reversed, holding Barrack qualified to sue in the United States District Court for the District of Massachusetts, because "the transferee district court must . . . apply the state law [concerning capacity to sue] that would have been applied if there had been no change of venue."⁵⁹³ The opinion cited *Erie*, *Klaxon*, and *York*, but not section 1652. The Court stated, "[a]lthough we deal here with a congressional statute apportioning the

⁵⁸⁹ 28 U.S.C. § 1404(a) (1993).

⁵⁹⁰ *Id.*

⁵⁹¹ 376 U.S. 612 (1964).

⁵⁹² *Van Dusen*, 376 U.S. at 614.

⁵⁹³ *Id.* at 639.

business of federal courts, our interpretation of that statute fully accords with and is supported by the policy underlying *Erie*.⁵⁹⁴ Peremptorily, it concluded, "the critical identity to be maintained is between the federal district court which decides the case and the courts of the State in which the action was filed."⁵⁹⁵

The Supreme Court mistakenly supposed itself seeking a rule of decision to answer this question: May a United States district court in which the plaintiff in the subject action has capacity to sue transfer that action under section 1404(a) to a United States district court in which the defendant can defeat the action on the ground that the plaintiff does not have capacity to sue?⁵⁹⁶ Having thus strayed off course, the Supreme Court sought its rule of decision in section 1404(a), which (in *provide-or-require* language) *provided* no answer. The Court looked to "the history and purposes of section 1404(a)"⁵⁹⁷ and—surreptitiously, as they thought necessary—to *Erie*. To answer their mischosen question "no" would limit section 1404(a)'s usefulness. To answer it "yes" would encroach upon the *Erie* line's mandate (as the Court apparently overread it) that a federal court's choice of law does not change an action's outcome, unless they ruled that an action transferred under section 1404(a) took the transferor court's rule of decision about capacity along with it to the transferee court. Thus, it concluded, in effect, that section 1404(a), read in *Erie*'s long shadow, *required* a decision that it simply "authorize[d] a change of courtrooms."⁵⁹⁸

That may well have been the most supportable reading of section 1404(a), had it been necessary to the case. But it was not. The Court had looked past this controlling antecedent question: Would a plaintiff who has capacity to sue in the United States district court of commencement have capacity to sue

⁵⁹⁴ *Id.* at 637.

⁵⁹⁵ *Id.* at 639.

⁵⁹⁶ *Id.* at 614.

⁵⁹⁷ *Van Dusen*, 376 U.S. at 636.

⁵⁹⁸ *Id.* at 637.

in the United States district court of destination? Only a negative answer to that question would have opened the door to the question the Supreme Court prematurely posed for itself. Where might it have looked for an answer to this controlling antecedent question? Rule 17(b) of the Federal Rules of Civil Procedure comes to mind. It came to the Court's mind, too, but only in miscegenous union with section 1404(a). This inquiry deals with that aspect of *Van Dusen* a little later on.⁵⁹⁹

In *Ferens v. John Deere Co.*,⁶⁰⁰ Ferens, a Pennsylvania farmer, sustained serious physical injury on his Pennsylvania farm, caused allegedly by a combine made by John Deere, a Delaware and Illinois company.⁶⁰¹ Because Pennsylvania's two-year statute of limitation on tort actions had run, but Mississippi's six-year statute had not, Ferens commenced his tort action against John Deere in United States District Court for the Southern District of Mississippi.⁶⁰² Invoking 28 U.S.C. section 1404(a), Ferens then successfully moved for the Mississippi district court to transfer this tort action to the United States District Court for the Western District of Pennsylvania.⁶⁰³ No one doubted this to be a transparent and enterprising manipulation of the first order. It was perhaps even a desperate move, considering the admonition in *Van Dusen* that whether "the same considerations would govern if a plaintiff sought transfer under section 1404(a)" remained undecided.⁶⁰⁴ The Pennsylvania district court merged the tort action with Ferens's action based on breach of contract and warranty theories.⁶⁰⁵ Ruling it barred by Pennsylvania's two-year statute of limitation, that court struck Ferens's tort theory.⁶⁰⁶ The United States Court of Appeals for the Third Circuit affirmed.⁶⁰⁷

⁵⁹⁹ See *infra* pp. 310-12.

⁶⁰⁰ 494 U.S. 516 (1990).

⁶⁰¹ *Ferens*, 494 U.S. at 519.

⁶⁰² *Id.*

⁶⁰³ *Id.* at 520.

⁶⁰⁴ *Van Dusen*, 376 U.S. at 640.

⁶⁰⁵ *Ferens*, 494 U.S. at 520.

⁶⁰⁶ *Id.* at 521.

⁶⁰⁷ *Id.*

On writ of certiorari, the Supreme Court reversed and remanded, saying, 5-4, that, "following a transfer under § 1404(a) initiated by a [plaintiff], the transferee court must follow the choice-of-law rules that prevailed in the transferor court."⁶⁰⁸ The majority opinion mentioned *Klaxon*, *Hanna*, *Erie*, *York*, and forum shopping, but not section 1652. It invoked Congress's purpose in enacting section 1404(a) and its own speculations about how the decision, or its converse, would affect the behavior of lawyers and judges, affect "the systemic costs"⁶⁰⁹ of litigation, and strike "the appropriate balance between fairness and simplicity."⁶¹⁰

Starting from *Klaxon* rather than section 1652, the opinion supposed that a statute of limitation provided by the law of some state would apply. *Provide-or-require* thinking points the same way. Section 1404(a) does not *provide* a statute of limitation. Section 1404(a) does not *require* a statute of limitation either. Even intentionalists, one supposes, could not claim so much. Again, no other federally enacted text comes to mind. Therefore, a statute of limitation provided by the law of some state must apply. But which state? Starting from *Erie* rather than section 1652 and applying intentionalist methodology to its interpretation of section 1404(a), the Supreme Court chose Mississippi, the state in which the federal court of commencement sat.⁶¹¹

Would *provide-or-require* thinking point the same way? Section 1404(a) does not *provide* a choice-of-law rule. Once again, even intentionalists, one expects, would not go so far. Does section 1404(a) *require* a choice-of-law rule? The Supreme Court apparently thought so. A *provide-or-require* intentionalist might agree. A *provide-or-require* textualist might not.⁶¹² The *provide-or-require* textualist who did not would then face a

⁶⁰⁸ *Id.* at 519.

⁶⁰⁹ *Id.* at 530.

⁶¹⁰ *Ferens*, 494 U.S. at 532.

⁶¹¹ *Id.* at 516.

⁶¹² See, e.g., ANTONIN SCALIA, A MATTER OF INTERPRETATION (1997); William N. Eskridge, Jr., *Textualism, The Unknown Ideal?*, 96 MICH. L. REV. 1509 (1998); William N. Eskridge, Jr., *The New Textualism*, 37 U.C.L.A. L. REV. 621 (1990).

conundrum. Section 1652 points to "[t]he law of the several states."⁶¹³ Whose law of limitation would that be? *Klaxon*, even a *provide-or-require* textualist's version of *Klaxon* ("in cases where they apply"), points to the forum state's choice-of-law rules to identify the controlling law of limitation. But which is "the forum state"? Conventional private international law provides no answer. Recognizing no inter-sovereign transfer for convenience, it has never faced the question. The "forum court" has always been both the court of commencement and the court of disposition. The law of *forum non conveniens* affords the closest analogy. Applying it would reduce the *provide-or-require* textualist (or, for that matter, interpreters of other persuasions) to divining what statute of limitation a Pennsylvania state court would have chosen in a hypothetical recommencement after a hypothetical dismissal *forum non conveniens* by a Mississippi state court. If unconditional, the recommencement court would, one supposes, apply conventional choice-of-law rules and choose the Pennsylvania statute. This conclusion would not support the *Ferens* majority's decision. If conditioned upon the moving defendant's agreement that the commencement court's statute of limitation follows the action to whatever recommencement court, the *provide-or-require* textualist (or other interpreter) would then have to divine whether the recommencement court must or would honor that agreement. A "yes" answer would vindicate the *Ferens* decision.

Speaking for himself and three other dissenters, Justice Scalia cited section 1652 and compared the majority's approach (don't let *Klaxon* interfere with section 1404(a)) with his own (don't let section 1404(a) interfere with the Rules of Decision Act), saying:

I think my approach preferable, not only because the Rules of Decision Act does, and section 1404(a) does not, address the specific subject of which law to apply, but also because, as the Court acknowledges, our jurisprudence under that statute is "a vital expression of the federal system and the concomitant

⁶¹³ 28 U.S.C. § 1652 (1970).

integrity of the separate States. . . .⁶¹⁴

He apparently thought the present case distinguishable from *Van Dusen*.⁶¹⁵

Justice Scalia's opinion translates easily into *provide-or-require* terms, at least through the first several steps. Not speaking to periods of limitation, section 1404(a) did not *provide* a statute of limitation for Ferens's tort theory. Nor, by a textualist's lights, did it *require* one. To maintain the course charted by section 1652, he would then have had to decide what statute of limitation a Pennsylvania state court would have chosen in a hypothetical recommencement after a hypothetical dismissal by a Mississippi state court. Here, however, there is not an involuntary dismissal *forum non conveniens* on the motion of defendants who opposed the forum, but a voluntary Rule 41(a) dismissal by the plaintiff who chose the forum. That is, the plaintiff would not have to invoke *forum non conveniens* to obtain a dismissal. Taking this to be the case, the Pennsylvania state court would, one supposes, apply conventional choice-of-law rules and choose the Pennsylvania statute, which would vindicate Justice Scalia's dissent.

On the other hand, how might the majority in *Ferens* have fared in the language of *provide-or-require*? It, too, one supposes, would have found no statute of limitation *provided* by section 1404(a). As to a straight-faced finding that section 1404(a) *required* application of Mississippi's six-year statute, perhaps the majority's intentionalist exegesis would have served it no less transparently married to *provide-or-require* thinking than it did married to *Erie* doctrine. Whether the majority would have thought so remains tantalizingly unanswered.

Between these two opinions came *Stewart Organization, Inc. v. Ricoh Corp.*,⁶¹⁶ by comparison, a much easier decision for the Court. Stewart sued Ricoh in United States District Court for the Northern District of Alabama to recover damages

⁶¹⁴ *Ferens*, 494 U.S. at 539 (emphasis added) (Scalia, J., dissenting).

⁶¹⁵ *Id.* at 534-36 (Scalia, J., dissenting).

⁶¹⁶ 487 U.S. 22 (1988).

for breach of a dealership contract, breach of warranty, fraud, and federal antitrust violations.⁶¹⁷ The dealership contract contained a forum-selection clause naming "any appropriate state or federal district court" in Manhattan.⁶¹⁸ Relying upon this clause, Ricoh moved the district court to transfer the action to the United States District Court for the Southern District Court of New York or, alternatively, to dismiss the action.⁶¹⁹ The district court denied the motion, finding the forum-selection clause unenforceable under Alabama state law.⁶²⁰ The Eleventh Circuit Court of Appeals reversed.⁶²¹ On writ of certiorari, the Supreme Court affirmed, 8-1.⁶²² The majority found its decision *required* by section 1404(a) of the United States Code, although section 1404(a) "nowhere mentions contracts or agreements, much less that the validity of certain contracts or agreements will be matters of federal law."⁶²³ For the majority, Justice Marshall said:

Section 1404(a) is intended to place discretion in the district court to adjudicate motions for transfer according to an "individualized, case-by-case consideration of convenience and fairness. . . ." A motion to transfer under § 1404(a) thus calls on the district court to weigh in the balance a number of case-specific factors. The presence of a forum-selection clause such as the parties entered into in this case will be a significant factor that figures centrally in the district court's calculus.⁶²⁴

He went on:

[T]he District Court will have either to integrate the factor of the forum-selection clause into its weighing of considerations as prescribed by Congress [in section 1404(a)], or else to ap-

⁶¹⁷ *Stewart*, 487 U.S. at 24.

⁶¹⁸ *Id.* at 24 n.1.

⁶¹⁹ *Id.* at 24; see 28 U.S.C. §§ 1404(a), 1406 (1994)

⁶²⁰ *Stewart*, 487 U.S. at 24.

⁶²¹ *Id.* at 25.

⁶²² *Id.* at 32.

⁶²³ *Id.* at 37 (Scalia, J., dissenting).

⁶²⁴ *Id.* at 29 (citations omitted).

ply, as it did in this case, Alabama's categorical policy disfavoring forum-selection clauses. Our cases make clear that, as between these two choices in a single "*field of operation*, . . ." the instructions of Congress are supreme.⁶²⁵

Here was *provide-or-require* reasoning in all but name. The opinion continued:

Congress has directed that multiple considerations govern transfer within the federal court system, and a state policy focusing on a single concern or a subset of the factors identified in section 1404(a) would defeat that command. Its application would impoverish the flexible and multifaceted analysis that Congress intended to govern motions to transfer within the federal system. The forum-selection clause, which represents the parties' agreement as to the most proper forum, should receive neither dispositive consideration . . . nor no consideration . . . , but rather the consideration for which Congress *provided* in section 1404(a).⁶²⁶

The opinion concluded:

Because 1404(a) controls the issue before the District Court, it must be applied if it represents a valid exercise of Congress's authority under the Constitution. The constitutional authority of Congress to enact 1404(a) is not subject to serious question.⁶²⁷

The opinion did not cite section 1652, but it arguably recognized it implicitly when it said, "when the federal law sought to be applied is a congressional statute, the first and chief question for the district court's determination is whether the statute is 'sufficiently broad to control the issue before the Court.'"⁶²⁸ The Court set *Erie* aside, saying, "[w]hether to apply a federal statute such as section 1404(a) in a diversity action, however, involves a considerably less intricate analysis than that which

⁶²⁵ *Stewart*, 487 U.S. at 30 (emphasis added) (citations omitted).

⁶²⁶ *Id.* at 31 (emphasis added).

⁶²⁷ *Id.* at 31-32.

⁶²⁸ *Id.* at 26.

governs the 'relatively unguided Erie choice.'⁶²⁹

That is, when a federally enacted text *provides* or *requires* the rule of decision, discussion about forum shopping and outcome determination hits wide of the mark.

In dissent, Justice Scalia argued (1) that the controlling question was "the validity between the parties of a forum-selection clause" and (2) that the answer to that question fell outside the scope of section 1404(a).⁶³⁰ He said:

[W]hen a federal procedural statute or Rule of Procedure is not on point, substantial uniformity of predictable outcome between federal and state courts in adjudicating claims should be striven for. . . . [I]n deciding whether a federal procedural statute or Rule of Procedure encompasses a particular issue, *a broad reading that would create significant disuniformity between state and federal courts should be avoided if the text permits.* . . .⁶³¹

Here, Justice Scalia put his finger on Erie doctrine's legitimate subordinated role in a back-to-the-statute *provide-or-require* exegesis of section 1652. When an act of Congress purports to *provide* a certain rule of decision, the constitutional concerns embodied by the Erie doctrine may play a part in testing the act's constitutionality. When an act of Congress purports only to *require* a certain rule of decision, the constitutional concerns embodied by the Erie doctrine may also play a part in answering the antecedent question whether the act really does *require* a rule of decision that would conflict with state law.

9) 18 U.S.C. § 610⁶³²

In *Cort v. Ash*,⁶³³ the Supreme Court found that United States Code Title 18, section 610, did not *require* certain feder-

⁶²⁹ *Id.* (footnote omitted).

⁶³⁰ *Stewart*, 487 U.S. at 34-35 (Scalia, J., dissenting).

⁶³¹ *Id.* at 37-38 (Scalia, J., dissenting) (emphasis added) (citations omitted).

⁶³² 18 U.S.C. § 610 (1970), *repealed by* Pub. L. 94-283, Title II, § 201(a), May 11, 1976, 90 Stat. 496.

⁶³³ 422 U.S. 66 (1975).

al rules of decision.⁶³⁴ Ash, owner of 50 shares of Bethlehem Steel stock, sued Cort, chairman of the board of Bethlehem Steel, in the United States District Court for the Eastern District of Pennsylvania, on behalf of himself and Bethlehem Steel, to enjoin Cort from expending general corporate funds in violation of section 610's proscription of corporate expenditures in connection with the 1972 presidential election and for compensatory and punitive damages for past expenditures.⁶³⁵ The district court granted Cort's motion for summary judgment.⁶³⁶ The United States Court of Appeals for the Third Circuit reversed, implying a private claim for relief under section 610.⁶³⁷ On writ of certiorari, the Supreme Court reversed unanimously.⁶³⁸ Justice Brennan wrote:

[A] private cause of action for damages against corporate directors is [not] to be implied in favor of a corporate stockholder under 18 U.S.C. section 610, a criminal statute prohibiting corporations from making "a contribution or expenditure in connection with any election at which Presidential and Vice Presidential electors . . . are to be voted for."⁶³⁹

The opinion cited *Bivens* and *Borak*, but not *Erie* or the Rules of Decision Act.

10) *Securities Exchange Act of 1934, Sections 14(a) & 27*⁶⁴⁰

In *J.I. Case Co. v. Borak*,⁶⁴¹ the Supreme Court decided that sections 14(a) and 27 of the Securities Exchange Act of 1934 did *require* certain federal rules of decision. Borak, owner of 2,000 shares of common stock in J.I. Case Co. common stock, sued Case in the United States District Court for the Eastern

⁶³⁴ *Cort*, 422 U.S. at 69.

⁶³⁵ *Id.* at 71-72.

⁶³⁶ *Id.* at 73.

⁶³⁷ *Id.* at 74.

⁶³⁸ *Id.*

⁶³⁹ *Cort*, 422 U.S. at 68.

⁶⁴⁰ 15 U.S.C. §§ 78n(a), 78aa (1997).

⁶⁴¹ 377 U.S. 426 (1964). See *Lampf v. Gilbertson*, 501 U.S. 350 (1991) (requiring litigation to be instituted as provided in federal act).

District of Wisconsin, on behalf of himself and all stockholders similarly situated, to enjoin a merger with the American Tractor Company and, if that failed, to nullify the merger and recover damages.⁶⁴² The district court dismissed Borak's state law claim for failure to post the statutorily required bond and all of Borak's federal claim but the possibility of declaratory relief under section 14(a) of the Securities Exchange Act of 1934.⁶⁴³ The United States Court of Appeals for the Seventh Circuit reversed on both counts.⁶⁴⁴ On writ of certiorari, the Supreme Court affirmed.⁶⁴⁵ Said Justice Clark:

section 27 of the [Securities Exchange] Act authorizes a federal cause of action for rescission or damages to a corporate stockholder with respect to a consummated merger which was authorized pursuant to the use of a proxy statement alleged to contain false and misleading statements violative of section 14(a) of the Act.⁶⁴⁶

The opinion cited *Lincoln Mills*, *Bell v. Hood*, and *Sola Electric*, but not *Erie* or the Rules of Decision Act.

11) *The Civil Rights Acts*⁶⁴⁷

In *Robertson v. Wegmann*,⁶⁴⁸ the Supreme Court held, 6-3, that 42 U.S.C. section 1988 did not *require* a uniform rule of decision favoring the survival of a civil rights action.⁶⁴⁹ The Court noted, however, "We intimate no view, moreover, about whether abatement based on state law could be allowed in a situation in which deprivation of federal rights caused death."⁶⁵⁰ In dissent, Justice Blackmun said:

Just as the Rules of Decision Act cases disregard state law

⁶⁴² *Borak*, 377 U.S. at 429-30.

⁶⁴³ *Id.* at 427-28; see 15 U.S.C. § 78n(a) (1994).

⁶⁴⁴ *Id.* at 428.

⁶⁴⁵ *Id.* at 435.

⁶⁴⁶ *Id.* at 428.

⁶⁴⁷ 42 U.S.C. § 1981-2000 (1994).

⁶⁴⁸ 436 U.S. 584 (1978).

⁶⁴⁹ *Robertson*, 436 U.S. at 590.

⁶⁵⁰ *Id.* at 594.

where there is conflict with federal *policy*, even though no explicit conflict with the terms of a federal statute, so, too, state remedial and procedural law must be disregarded under [42 U.S.C.] section 1988 where that law fails to give adequate expression to important federal concerns.⁶⁵¹

That is to say, federally enacted texts may *require* certain rules of decision even where those texts do not *provide* them. Justice Blackmun characterized the Rules of Decision Act as "the other major choice-of-law provision in the federal structure."⁶⁵²

12) *The Migratory Bird Conservation Act*⁶⁵³

In *United States v. Little Lake Misere Land Co.*,⁶⁵⁴ the United States commenced an action in the United States District Court for the Western District of Louisiana to quiet title in real property acquired by authority of the Migratory Bird Conservation Act.⁶⁵⁵ The deeds contained prescriptability provisions upon which the United States relied.⁶⁵⁶ The district court rendered judgment for the defendant.⁶⁵⁷ The United States Court of Appeals for the Fifth Circuit affirmed.⁶⁵⁸ On writ of certiorari, the Supreme Court reversed and remanded to render judgment for the United States.⁶⁵⁹ The majority opinion concluded (1) that contractual prescriptability posed a federal question under the MGCA according to *Clearfield Trust* and (2) that incorporation of state law, which would have *retroactively* invalidated the contractual prescriptability provisions of these deals, would not be appropriate.⁶⁶⁰ Said Chief Justice Burger, "[t]he suggestion is that this Court's decision in *Erie R. Co. v. Tompkins* compels application of state law here because

⁶⁵¹ *Id.* at 598 (Blackmun, J., dissenting).

⁶⁵² *Id.* at 597 (Blackmun, J., dissenting).

⁶⁵³ 16 U.S.C. § 715 (1985).

⁶⁵⁴ 412 U.S. 580 (1973).

⁶⁵⁵ *Little Lake Misere Land*, 412 U.S. at 582.

⁶⁵⁶ *Id.* at 583.

⁶⁵⁷ *Id.* at 584.

⁶⁵⁸ *Id.*

⁶⁵⁹ *Id.* at 604.

⁶⁶⁰ *Little Lake Misere Land*, 412 U.S. at 595.

the Rules of Decision Act, 28 U.S.C. § 1652, requires application of state law in the absence of an *explicit* congressional command to the contrary. We disagree.”⁶⁶¹

“[T]he inevitable incompleteness presented by all legislation,” he reasoned, “means that interstitial federal lawmaking is a basic responsibility of the federal courts.”⁶⁶² In concurrence, Justice Stewart said: “This retroactive application of Act 315, I believe, is a textbook example of a violation of Art. I, section 10, cl. 1, of the Constitution, which provides that no State shall pass any law ‘impairing the Obligation of Contracts.’”⁶⁶³

*b. The Rules Enabling Act*⁶⁶⁴

When a rule or regulation authorized by an act of Congress⁶⁶⁵ purports to *provide* or *require* a certain rule of decision, the constitutional concerns embodied by Erie doctrine may play parts at additional decision points. That is, they may bear upon (1) the question whether Congress could constitutionally *provide* or *require* the rule of decision contended for and (2) the question whether the rule of decision contended for lies within the authority granted by Congress to the rulemaking body. The Rules Enabling Act, presently 28 U.S.C. section 2072, reads:

⁶⁶¹ *Id.* at 591 (emphasis added) (citation omitted).

⁶⁶² *Id.* at 593.

⁶⁶³ *Id.* at 606 (Stewart, J., concurring). In concurrence, Justice Rehnquist chose another ground, cautioning that Justice Stewart’s conclusion seemed doubtful after *Home Building & Loan Ass’n v. Blaisdell*, 290 U.S. 398 (1934). *Little Lake*, 412 U.S. at 607 (Rehnquist, J., concurring). In *Blaisdell*, on an appeal from a decision of the Minnesota Supreme Court, the United States Supreme Court held, 5-4, that the Minnesota Mortgage Moratorium Law, which extended the period of redemption under conditions prescribed to protect creditors, did not violate the Contracts Clause. *Blaisdell*, 290 U.S. at 416. In a close call, the majority distinguished *Bronson v. Kinzie*. *Id.* at 431-32. The Four Horsemen dissented. *Id.* at 448 (Sutherland, J., dissenting). I do not share then Justice Rehnquist’s reservations. Courts have always withheld enforcement of contracts deemed contrary to public policy. What courts deem contrary to public policy changes with the times.

⁶⁶⁴ 28 U.S.C. § 2072 (1994).

⁶⁶⁵ See the rule-making authority conferred generally by 28 U.S.C. § 2071 (1994).

(a) The Supreme Court shall have the power to prescribe general rules of practice and procedure and rules of evidence for cases in the United States district courts (including proceedings before magistrates thereof) and courts of appeals.

(b) Such rules shall not abridge, enlarge or modify any substantive right. All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect.

(c) Such rules may define when a ruling of a district court is final for the purposes of appeal under section 1291 of this title.⁶⁶⁶

The Supreme Court has had opportunities to fit the Rules Enabling Act properly into section 1652's mandate in cases implicating Rules 3, 4(d)(1), 4(f), 8(c), 11, 17(b), 23, 23.1, 35, and 59(a) of the Federal Rules of Civil Procedure, and Rule 38 of the Federal Rules of Appellate Procedure.

*1) Rule 3 of the Federal Rules of Civil Procedure*⁶⁶⁷

Rule 3 provides in full: "A civil action is commenced by filing a complaint with the court."⁶⁶⁸

In addition to the importance of *Ragan v. Merchants Transfer & Warehouse Co.*⁶⁶⁹ as an early opportunity to fit the Federal Rules of Civil Procedure into section 1652's mandate, the reasoning in *Ragan* dramatizes how far two historical accidents,⁶⁷⁰ *Swift* and *Erie*, have estranged fashionable thought

⁶⁶⁶ 28 U.S.C. § 2072 (1994).

⁶⁶⁷ FED. R. CIV. P. 3.

⁶⁶⁸ *Id.*

⁶⁶⁹ 337 U.S. 530 (1949).

⁶⁷⁰ "Apparent" historical accidents? The writings of Stephen Jay Gould notwithstanding, I do not *know* that we live in a "world of contingency," STEPHEN JAY GOULD, FULL HOUSE 69 (1996), if "knowing" means enjoying certitude beyond any reasonable doubt. Professor Gould stands on solid ground insofar as we can understand him to insist only upon Niels Bohr's definition of scientific knowledge, that is, scientists *as scientists* must draw only those conclusions supported by the data presently at hand. Those data arguably do support Professor Gould's insistence upon "radical contingency." *Id.* at 214. (I cite only the source closest at hand. The theme of radical contingency runs through much of Professor Gould's writings.) Whether the data available, say, a hundred years from now will still suggest a "world of contingency" is the stuff of philosophy, not present science.

from section 1652. The plaintiff commenced his tort action in United States District Court for the District of Kansas less than two years after the accident giving rise to it.⁶⁷¹ The defendant received service of process more than two years after the accident.⁶⁷² Section 60-306 of the Kansas General Statutes provided a two-year statute of limitation for tort actions such as plaintiff's.⁶⁷³ Section 60-308 provided that "[a]n action shall be deemed commenced within the meaning of this article . . . at the date of the summons which is served on him"⁶⁷⁴ The district court refused to hold the plaintiff's action barred by the statute of limitation and eventually rendered judgment for the plaintiff.⁶⁷⁵ The Tenth Circuit Court of Appeals reversed.⁶⁷⁶ On writ of certiorari, the Supreme Court affirmed.⁶⁷⁷ Justice Douglas wrote, "It is conceded that if the present case were in a Kansas court it would be barred. The theory of *Guaranty Trust Co. v. York* would therefore seem to bar it in the federal court, as the Court of Appeals held."⁶⁷⁸ "The force of that reasoning," continued the opinion,

is sought to be avoided by the argument that the Federal Rules of Civil Procedure determine the manner in which an action is commenced in the federal courts—a matter of procedure which the principle of *Erie R. Co. v. Tompkins* does not control. It is accordingly argued that since the suit was properly commenced in the federal court before the Kansas statute of limitations ran, it tolled the statute.⁶⁷⁹

"But," the opinion responded,

in the present case we look to local law to find the cause of action on which suit is brought. It accrues and comes to an

⁶⁷¹ *Ragan*, 337 U.S. at 531.

⁶⁷² *Id.*

⁶⁷³ *Id.* at n.3.

⁶⁷⁴ *Id.* at n.4.

⁶⁷⁵ *Id.* at 532.

⁶⁷⁶ *Ragan*, 337 U.S. at 532.

⁶⁷⁷ *Id.* at 534.

⁶⁷⁸ *Id.* at 532.

⁶⁷⁹ *Id.* at 532-33.

end when local law so declares. . . . Where local law qualifies or abridges it, the federal court must follow suit. Otherwise there is a different measure of the cause of action in one court than in the other, and *the principle of Erie R. Co. v. Tompkins is transgressed*.⁶⁸⁰

How about that? "[T]he principle of *Erie R. Co. v. Tompkins* is transgressed,"⁶⁸¹ not the letter or *ratio scripta* of section 1652, which the opinion did not even acknowledge.

The Court might as readily have supported its decision by concluding they found nothing in the United States Constitution, a treaty of the United States, an act of Congress, or a rule adopted by and within the authority of a valid act of Congress *providing* or *requiring* a certain definition of "commence" for this automobile negligence action. To the plaintiff's reliance upon the definition of "commence" provided by Rule 3 of the Federal Rules of Civil Procedure, the Court might have responded that Rule 3 provides the definition of "commence" only for purposes internal to the Federal Rules of Civil Procedure. That is, wherever an entitlement or obligation provided by some other rule of the Federal Rules of Civil Procedure depends upon *commencement*, Rule 3's definition controls; but wherever an entitlement or obligation provided by some other rule of decision (whether state or federal) depends on *commencement*, Rule 3's definition does not, or not necessarily,⁶⁸² control. In doing so, the Court might have invoked *Palmer v. Hoffman*,⁶⁸³ wherein an earlier membership had held the ordering of burdens of proof beyond the scope of Rule 8(c) of the Federal Rules of Civil Procedure.⁶⁸⁴

Provide-or-require disciples not persuaded by this reasoning must, arguably, conclude that the decision in *Ragan* went astray. Within its purview, Rule 3 does not merely *require* some rule of definitional decision, it *provides* one. This leaves

⁶⁸⁰ *Id.* at 533 (emphasis added) (citations omitted).

⁶⁸¹ *Ragan*, 337 U.S. at 533.

⁶⁸² *See West v. Conrail*, 481 U.S. 35, 39 (1987).

⁶⁸³ 318 U.S. 109 (1943). *See infra* p. 304.

⁶⁸⁴ *Palmer*, 318 U.S. at 117.

less, if any, room for temporizing about policies, and that goes as well for the policy underlying *York*'s outcome determination test as for any other.

In *Walker v. Armco Steel Corp.*,⁶⁸⁵ the Supreme Court offered substantially the explanation it might and should have given in *Ragan*, reanalyzing its interpretation of Rule 3 in light of its intervening decision in *Hanna v. Plumer*,⁶⁸⁶ to say nothing of its earlier decision in *Palmer v. Hoffman*.⁶⁸⁷ The plaintiff commenced his products liability action in United States District Court for the Western District of Oklahoma less than two years after the accident giving rise to it.⁶⁸⁸ The defendant received service of process more than two years after the accident.⁶⁸⁹ Oklahoma had a two-year statute of limitation derived from and substantially like the Kansas statute applied in *Ragan v. Merchants Transfer & Warehouse Co.*⁶⁹⁰ On the defendant's motion, the district court dismissed the plaintiff's action.⁶⁹¹ The Tenth Circuit Court of Appeals affirmed.⁶⁹² On writ of certiorari, the Supreme Court affirmed, reaffirming *Ragan* over the plaintiff's argument that *Hanna* had implicitly overruled it.⁶⁹³ Quoting from *Hanna*, Justice Marshall explained that *Ragan* did not hold

that *Erie* commanded displacement of a Federal Rule by an inconsistent state rule, but rather that the scope of the Federal Rule was not as broad as the losing party urged, and therefore, there being no Federal Rule which covered the point in dispute, *Erie* commanded the enforcement of state law.⁶⁹⁴

⁶⁸⁵ 446 U.S. 740 (1980).

⁶⁸⁶ 380 U.S. 460 (1965). See *infra* pp. 301-03.

⁶⁸⁷ 318 U.S. 109 (1943). See *infra* p. 304.

⁶⁸⁸ *Walker*, 446 U.S. at 741-42.

⁶⁸⁹ *Id.* at 742.

⁶⁹⁰ *Id.* at 742-43.

⁶⁹¹ *Ragan*, 337 U.S. at 743.

⁶⁹² *Id.* at 744.

⁶⁹³ *Walker*, 446 U.S. at 744, 749.

⁶⁹⁴ *Id.* at 748.

"Erie commanded the enforcement of state law,"⁶⁹⁵ not the long-suffering Rules of Decision Act, now cloistered in section 1652. Applying this proposition to Rule 3, Justice Marshall wrote:

Rule 3 simply states that "[a] civil action is commenced by filing a complaint with the court." There is no indication that the Rule was intended to toll a state statute of limitations, much less that it purported to displace state tolling rules for purposes of state statutes of limitations. In our view, in diversity actions *Rule 3 governs the date from which various timing requirements of the Federal Rules begin to run*, but does not affect state statutes of limitations.⁶⁹⁶

Although the opinion did not cite section 1652, it thus far squared comfortably with *provide-or-require* reasoning (or, as it were, "not required by" reasoning). Only the influence of *Erie* thinking might explain why Justice Marshall felt moved to continue:

[T]he policies behind *Erie* and *Ragan* control the issue whether, in the absence of a federal rule directly on point, state service requirements which are an integral part of the state statute of limitations should control in an action based on state law which is filed in federal court under diversity jurisdiction.⁶⁹⁷

He then seemed momentarily to shake off that influence, saying:

There is simply no reason why, *in the absence of a controlling federal rule*, an action based on state law which concededly would be barred in the state courts by the state statute of limitations should proceed through litigation to judgment in federal court solely because of the fortuity that there is diversity of citizenship between the litigants. The *policies underlying diversity jurisdiction* do not support such a distinc-

⁶⁹⁵ *Id.* (emphasis added).

⁶⁹⁶ *Id.* at 750-51 (alteration in original) (emphasis added) (footnotes omitted). Compare *West v. Conrail*, 481 U.S. 35, 39 (1987).

⁶⁹⁷ *Walker*, 446 U.S. at 752-53.

tion between state and federal plaintiffs ⁶⁹⁸

Then, however, he relapsed, adding: "and *Erie* and its progeny do not permit it."⁶⁹⁹

2) *Rule 4(d)(1) of the Federal Rules of Civil Procedure*⁷⁰⁰

As it appeared in 1965, Rule 4(d)(1) said:

The summons and complaint shall be served together. The plaintiff shall furnish the person making service with such copies as are necessary. Service shall be made as follows: (1) Upon an individual other than an infant or an incompetent person, by delivering a copy of the summons and of the complaint to him personally or by leaving copies thereof at his dwelling house or usual place of abode with some person of suitable age and discretion then residing therein ⁷⁰¹

The substantial equivalent now appears in Rule 4(e)(2).⁷⁰²

After failing to recognize several earlier opportunities,⁷⁰³ the Supreme Court at last accepted the challenge, although arguably only obliquely, to fit the Federal Rules of Civil Procedure into section 1652's mandate. Rule 4(d)(1) and *Hanna v. Plumer*⁷⁰⁴ provided the vehicles.

Hanna, not a citizen of Massachusetts, sued Plumer, a citizen of Massachusetts, in United States District Court in Massachusetts to recover damages for injuries allegedly sustained in a collision in South Carolina with an automobile driven by Plumer's decedent.⁷⁰⁵ Hanna served Plumer with

⁶⁹⁸ *Id.* at 753 (emphasis added).

⁶⁹⁹ *Id.*

⁷⁰⁰ FED. R. CIV. P. 4(d)(1) (1992) (amended Apr. 22, 1993).

⁷⁰¹ *Id.*

⁷⁰² FED. R. CIV. P. 4(e)(2).

⁷⁰³ See, e.g., *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949); *Woods v. Interstate Realty Co.*, 337 U.S. 535 (1949); *Ragan v. Merchants Transfer & Warehouse Co.*, 337 U.S. 530 (1949); *Mississippi Publg. Corp. v. Murphree*, 326 U.S. 438 (1946); *Palmer v. Hoffman*, 318 U.S. 109 (1943); *Sibbach v. Wilson & Co.*, 312 U.S. 1 (1941).

⁷⁰⁴ 380 U.S. 460 (1965).

⁷⁰⁵ *Hanna*, 380 U.S. at 461.

process, as permitted by Federal Rule 4(d)(1), by handing copies of the summons and complaint to Plumer's wife at Plumer's residence.⁷⁰⁶ Massachusetts state law did not authorize residence service on a personal representative.⁷⁰⁷ Plumer timely objected to the manner of service after the statute of limitation on Hanna's claim had run.⁷⁰⁸ Thus, the court's decision on the objection, if for Plumer, had become outcome determinative.⁷⁰⁹ The district court ruled for Plumer.⁷¹⁰ The court of appeals affirmed.⁷¹¹ The Supreme Court reversed.⁷¹² Wrote Chief Justice Warren:

[T]he adoption of Rule 4(d)(1) . . . *neither exceeded the congressional mandate embodied in the Rules Enabling Act nor transgressed constitutional bounds*[.] . . . [T]he Rule is therefore the standard against which the District Court should have measured the adequacy of the service.⁷¹³ . . . [T]he court has been instructed to apply the Federal Rule, and can refuse to do so only if the Advisory Committee, this Court, and Congress erred in their *prima facie* judgment that the Rule in question transgresses neither the terms of the Enabling Act nor constitutional restrictions.⁷¹⁴

So neatly does this language square with section 1652's *provide-or-require* mandate that one expects to find section 1652 featured prominently in the opinion. One comes away disappointed. Instead, the opinion worked its way laboriously around, rather than over, the hurdles posed by *Erie* and *York*, rejecting "the incorrect assumption that the rule of *Erie R. Co. v. Tompkins* constitutes the appropriate test of the validity and therefore the applicability of a Federal Rule of Civil Proce-

⁷⁰⁶ *Id.*

⁷⁰⁷ *Id.* at 461-62.

⁷⁰⁸ *Id.*

⁷⁰⁹ *Id.* at 469.

⁷¹⁰ *Hanna*, 380 U.S. at 462.

⁷¹¹ *Id.* at 462-63.

⁷¹² *Id.* at 464.

⁷¹³ *Id.* at 463-64 (emphasis added).

⁷¹⁴ *Id.* at 471.

ture.”⁷¹⁵

Other Justices, thinking in the shadow of a different history, could have reached and supported the same decision by consciously applying section 2072 (the Rules Enabling Act) *through* section 1652 (the Rules of Decision Act), rather than *around* it or without it.⁷¹⁶ Guided by the sure hand of section 1652, they could have found their rule of decision *provided* by (not merely *required* by) a rule adopted by and within the authority of a valid act of Congress, that is, Rule 4(d)(1), Federal Rules of Civil Procedure, adopted by and within the authority of Congress’s Rules Enabling Act, constitutionally valid as to the grant of authority supporting Rule 4(d)(1). In monitoring those conclusions, Erie doctrine would have exhausted its legitimate office. No room would have remained for additional rhetoric about forum shopping or outcome determination.

3) Rule 4(f) of the Federal Rules of Civil Procedure⁷¹⁷

In 1946, Rule 4(f) provided: “All process other than a subpoena may be served anywhere within the territorial limits of the state in which the district court is held.”⁷¹⁸ The substantial equivalent, worded quite differently, now appears in Rule 4(k).⁷¹⁹

In *Mississippi Publishing Corp. v. Murphree*,⁷²⁰ Murphree commenced his libel action against the Mississippi Publishing Corporation in the United States District Court for the Northern District of Mississippi.⁷²¹ Mississippi Publishing, a Delaware corporation, had an office and place of business in the southern district of Mississippi and received in-hand service of process there.⁷²² The district court granted the defendant’s motion to dismiss for want of proper venue and want of juris-

⁷¹⁵ *Hanna*, 380 U.S. at 469-70.

⁷¹⁶ *See supra* pp. 185-89.

⁷¹⁷ FED. R. CIV. P. 4(f) (1992) (amended 1993).

⁷¹⁸ *Id.*

⁷¹⁹ FED. R. CIV. P. 4(k).

⁷²⁰ 326 U.S. 438 (1946).

⁷²¹ *Murphree*, 326 U.S. at 439.

⁷²² *Id.* at 439-40.

diction over its person.⁷²³ The United States Court of Appeals for the Fifth Circuit reversed.⁷²⁴ On writ of certiorari, the Supreme Court affirmed.⁷²⁵ According to the Justices, Rule 4(f) of the Federal Rules of Civil Procedure authorized statewide service of process out of any federal district within the state.⁷²⁶ Its opinion held Rule 4(f) to be "a rule of procedure and not of substantive right" and, therefore, a valid exercise of the rulemaking authority delegated by the Rules Enabling Act.⁷²⁷ The opinion did not cite *Erie*; it did cite *Sibbach v. Wilson & Co.* and *Guaranty Trust Co. v. York*, but made little of them.⁷²⁸ It did not cite the Rules of Decision Act, but its reasoning squares comfortably with explicit *provide-or-require* reasoning.⁷²⁹ If the decision went astray, it did so in holding Rule 4(f), as the Court interpreted it, a valid exercise of the authority delegated by section 2072.⁷³⁰

4) *Rule 8(c) of the Federal Rules of Civil Procedure*⁷³¹

Rule 8(c) provides: "In pleading to a preceding pleading, a party shall set forth affirmatively accord and satisfaction, arbitration and award, assumption of risk, contributory negligence, discharge in bankruptcy, duress, estoppel, failure of consideration, fraud, illegality, injury by fellow servant, laches, license, payment, release, res judicata, statute of frauds, statute of limitations, waiver, and any other matter constituting an avoidance or affirmative defense. . . ."⁷³²

In *Palmer v. Hoffman*,⁷³³ Hoffman sued Palmer (trustee for the railroad company) in the United States District Court

⁷²³ *Id.* at 440.

⁷²⁴ *Id.*

⁷²⁵ *Id.* at 440, 446.

⁷²⁶ *Murphree*, 326 U.S. at 444.

⁷²⁷ *Id.* at 446.

⁷²⁸ *Id.* at 445-46.

⁷²⁹ *Id.* at 445.

⁷³⁰ *Id.*

⁷³¹ FED. R. CIV. P. 8(c).

⁷³² *Id.*

⁷³³ 318 U.S. 109 (1943).

for the Eastern District of New York to recover damages for injuries sustained in a railroad crossing accident occurring in Massachusetts.⁷³⁴ Over Palmer's objection, the district court instructed the jury that the railroad bore the burden of proving Hoffman's alleged contributory negligence.⁷³⁵ The district court rendered judgment on a jury verdict for Hoffman.⁷³⁶ The United States Court of Appeals affirmed.⁷³⁷ On writ of certiorari, the Supreme Court affirmed.⁷³⁸ In doing so, however, it rejected Hoffman's contention that Rule 8(c) of the Federal Rules of Civil Procedure provided the controlling rule of decision.⁷³⁹ According to Justice Douglas, "Rule 8(c) covers only the manner of pleading," thus limiting Rule 8(c)'s scope to leave Massachusetts law controlling the federal court's decisions about the burdens of proof.⁷⁴⁰ The opinion cited *Erie and Cities Services Oil Co. v. Dunlap* without comment.⁷⁴¹ It did not cite the Rules of Decision Act, then title 28, section 725, although its reasoning squares comfortably with explicit *provide-or-require* reasoning.

5) *Rule 11 of the Federal Rules of Civil Procedure*⁷⁴²

As it appeared before amendment in 1993, Rule 11 read as follows:

Every pleading, motion, and other paper of a party represented by an attorney shall be signed by at least one attorney of record in the attorney's individual name, whose address shall be stated. A party who is not represented by an attorney shall sign the party's pleading, motion, or other paper and state the party's address. Except when otherwise specifically provided by rule or statute, pleadings need not be verified or

⁷³⁴ *Hoffman*, 318 U.S. at 110.

⁷³⁵ *Id.* at 116.

⁷³⁶ *Id.* at 110-11.

⁷³⁷ *Id.* at 111.

⁷³⁸ *Id.* at 111, 120.

⁷³⁹ *Hoffman*, 318 U.S. at 117.

⁷⁴⁰ *Id.*

⁷⁴¹ *Id.* at 117-19.

⁷⁴² FED. R. CIV. P. 11 (amended 1993).

accompanied by affidavit. The rule in equity that the averments of an answer under oath must be overcome by the testimony of two witnesses or of one witness sustained by corroborating circumstances is abolished. The signature of an attorney or party constitutes a certificate by the signer that the signer has read the pleading, motion or other paper; that to the best of the signer's knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation. If a pleading, motion, or other paper is not signed, it shall be stricken unless it is signed promptly after the omission is called to the attention of the pleader or movant. If a pleading, motion, or other paper is signed in violation of this rule, the court, upon motion or upon its own initiative, shall impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay to the other party or parties the amount of the reasonable expenses incurred because of the filing of the pleading, motion, or other paper, including a reasonable attorney's fee.

The Supreme Court has or could have held the now superseded version of Rule 11 up to section 1652 in the three cases next examined.

In *Business Guides, Inc. v. Chromatic Communications Enterprises, Inc.*,⁷⁴³ the Supreme Court held, 5-4, that Rule 11 sanctions apply to represented parties who sign papers without an objectively reasonable inquiry.⁷⁴⁴ Although no one asserted a competing provision of California law and no one cited *Erie* or section 1652, the case has importance for the present inquiry, because it showcases one of the essential inquiries when a rule depending upon section 2072 for its validity purports to *provide* or *require* a certain rule of decision.⁷⁴⁵ The majority and the

⁷⁴³ 498 U.S. 533 (1991).

⁷⁴⁴ *Business Guides*, 498 U.S. at 541.

⁷⁴⁵ *Id.*

dissenters disagreed about whether Rule 11 violated the Enabling Act's provision that rules enacted under its authority "shall not abridge, enlarge, or modify any substantive right."⁷⁴⁶ On its face, section 1652 does not expressly recognize a distinction between substance and procedure.⁷⁴⁷ Section 2072 injects that distinction into the calculus, but only necessarily with regard to rules of decision *provided or required* by a rule promulgated under section 2072's authority.

In *Pavelic & LeFlore v. Marvel Entertainment Group*,⁷⁴⁸ the United States District Court for the Southern District of New York imposed Rule 11 sanctions on Pavelic & LeFlore, a law firm, for maintaining an insupportable allegation of forgery.⁷⁴⁹ The firm (and certainly Pavelic, who had not signed the documents) appealed, arguing that Rule 11 authorized sanctions only against the signing attorney, not against his law firm.⁷⁵⁰ The Court of Appeals for the Second Circuit affirmed.⁷⁵¹ On writ of certiorari, the majority reversed over Justice Marshall's dissent.⁷⁵² Neither Congress's constitutional authority to enable Rule 11 as interpreted nor the Justices' authority under the enabling statute to write Rule 11 came into question.⁷⁵³ Neither the majority opinion nor the dissenting opinion considered whether its application of Rule 11 competed with a state law rule of decision.⁷⁵⁴ Neither the outcome nor the reasoning in either opinion is inconsistent with *provide-or-require* analysis.⁷⁵⁵

In *Cooter & Gell v. Hartmarx Corp.*,⁷⁵⁶ Cooter & Gell, a law firm, filed in the United States District Court for the Dis-

⁷⁴⁶ *Id.* at 551-52, 568.

⁷⁴⁷ It arguably does so, however, for those who define "rules of decision" to comprehend only rules bearing upon the merits.

⁷⁴⁸ 493 U.S. 120 (1989).

⁷⁴⁹ *Pavelic*, 493 U.S. at 122.

⁷⁵⁰ *Id.*

⁷⁵¹ *Id.*

⁷⁵² *Id.* at 123, 127.

⁷⁵³ *Id.*

⁷⁵⁴ *Pavelic*, 493 U.S. at 123, 127.

⁷⁵⁵ *Id.*

⁷⁵⁶ 496 U.S. 384 (1990).

trict of Columbia a reactive antitrust complaint against Hartmarx on behalf of Danik, Inc.⁷⁵⁷ Hartmarx responded with a motion to dismiss on the merits and a Rule 11 motion for sanctions.⁷⁵⁸ Cooter & Gell then dismissed the action under Rule 41(a)(1)(i).⁷⁵⁹ The district court subsequently levied Rule 11 sanctions against Cooter & Gell and Danik, Inc., ruling *inter alia* that the voluntary dismissal did not foreclose Rule 11 sanctions.⁷⁶⁰ The United States Court of Appeals for the District of Columbia Circuit affirmed.⁷⁶¹ On writ of certiorari, the Supreme Court affirmed this part of the lower courts' ruling.⁷⁶² The majority opinion did not question either Congress's constitutional authority to enable Rule 11 as interpreted or the Justices' authority under section 2072 to write Rule 11.⁷⁶³ The majority opinion did not consider whether its application of Rule 11 competed with a state law rule of decision.⁷⁶⁴ In dissent, Justice Stevens said the majority's application of Rule 11 "creates a federal common law of malicious prosecution inconsistent with the limited mandate of the Rules Enabling Act."⁷⁶⁵ Neither the outcome nor the reasoning in either opinion is inconsistent with *provide-or-require* analysis.

6) *Rule 17(b) of the Federal Rules of Civil Procedure*⁷⁶⁶

Rule 17(b) provided in 1949, and still provides, in pertinent part, that "[t]he capacity of a corporation to sue or be sued shall be determined by the law under which it was organized."⁷⁶⁷

In *Woods v. Interstate Realty Co.*,⁷⁶⁸ as on too many other

⁷⁵⁷ *Hartmarx*, 496 U.S. at 388-89.

⁷⁵⁸ *Id.* at 389.

⁷⁵⁹ *Id.*

⁷⁶⁰ *Id.* at 389-90.

⁷⁶¹ *Id.* at 390.

⁷⁶² *Hartmarx*, 496 U.S. at 398.

⁷⁶³ *Id.*

⁷⁶⁴ *Id.*

⁷⁶⁵ *Id.* at 410.

⁷⁶⁶ FED. R. CIV. P. 17(b).

⁷⁶⁷ *Id.*

⁷⁶⁸ 337 U.S. 535 (1949).

occasions, the Court's majority opinion did not cite section 1652. Again, one of the Federal Rules of Civil Procedure, this time Rule 17(b), might have suggested itself, but it was not cited. In *Woods*, Interstate Realty Co., a Tennessee corporation, sued Woods in the United States District Court for the District of Mississippi to recover a broker's commission for the sale of Mississippi real estate.⁷⁶⁹ The district court rendered summary judgment against Interstate, because Interstate "was doing business in Mississippi without qualifying under a Mississippi statute" that denied foreign corporate violators access to Mississippi state courts.⁷⁷⁰ The United States Court of Appeals for the Fifth Circuit reversed.⁷⁷¹ On writ of certiorari, the Supreme Court reversed the Fifth Circuit's decision.⁷⁷² Again relying solely on Erie doctrine, the majority

follow[ed] the view of *Guaranty Trust Co. v. York* . . . that for purposes of diversity jurisdiction a federal court is "in effect, only another court of the State. . . ." . . . [W]here in such cases one is barred from recovery in the state court, he should likewise be barred in the federal court. The contrary result would *create discriminations against citizens of the State* in favor of those authorized to invoke the diversity jurisdiction of the federal courts. It was that element of discrimination that *Erie R. Co. v. Tompkins* was designed to eliminate.⁷⁷³

Of course, a proper application of section 1652 would also eliminate "that element of discrimination."⁷⁷⁴

In dissent, Justice Jackson did cite section 1652, but made nothing of it, characterizing the majority's decision as "a perversion of . . . Erie . . . doctrine."⁷⁷⁵ He did not identify a pro-

⁷⁶⁹ *Woods*, 337 U.S. at 535-36.

⁷⁷⁰ *Id.* at 536.

⁷⁷¹ *Id.*

⁷⁷² *Id.* at 536, 538.

⁷⁷³ *Id.* at 538 (emphasis added). The opinion cited *Angel v. Bullington*, 330 U.S. 183 (1947), of which Justice Rutledge said, in dissent: "[The majority's] decision rests on an 'and/or' hodgepodge of res judicata and Erie doctrine." 330 U.S. at 201 (Rutledge, J., dissenting).

⁷⁷⁴ *Woods*, 337 U.S. at 538.

⁷⁷⁵ *Id.* at 540 (Jackson, J., dissenting).

vision of federally enacted law providing or requiring the rule of decision he deemed controlling. Instead, whether consciously or not, he interpreted section 1652 to permit a third category of cases, one to which neither established state law nor federal law applied, leaving the federal court free to fill the gap with a rule of its own choosing.⁷⁷⁶ By dissenting rather than concurring, he implied a rule permitting the foreign corporation to pursue its grievance in United States District Court. Where he got the rule he neglected to say. He might have cited Rule 17(b) of the Federal Rules of Civil Procedure, which provides: "The capacity of a corporation to sue or be sued [in United States District Court] shall be determined by the law under which it was organized."⁷⁷⁷ Not only would this have filled the gap created by his "three-categories" understanding of section 1652, it would have supported his dissent under a *provide-or-require* understanding of it as well.⁷⁷⁸

Had it been able to transcend the mindset of "these 'erieandtompinkinated' days,"⁷⁷⁹ the majority could also have defended its decision under the *provide-or-require* mandate. It could have concluded (1) that Rule 17(b) did not *provide* a rule for this case or (2) that, to the extent interpreted to override a state door-closing statute, Rule 17(b) was not a Rule adopted by and within the authority of a valid Act of Congress.⁷⁸⁰

⁷⁷⁶ See *supra* p. 175.

⁷⁷⁷ FED. R. CIV. P. 17(b).

⁷⁷⁸ See Laura E. Little, *Out of Woods and into the Rules: The Relationship between State Foreign Corporation Door-Closing Statutes and Federal Rule of Civil Procedure 17(b)*, 72 VA. L. REV. 769 (1986) (arguing Rule 17(b) is not rendered inoperable by state statutes, but rather provides clear standard for judging capacity of corporation to sue); Ely, *supra* note 1, at 727-28 (arguing Rule 17(b) applies because essential purpose of Mississippi statute was substantive, encouraging corporate qualification). But see 6A C. WRIGHT, A. MILLER, & M. KANE, *FEDERAL PRACTICE AND PROCEDURE* § 1561 at 449-50 (2d ed. 1990) (stating capacity of corporate plaintiff not to sue is, in effect, determined by laws of forum state, regardless of Rule 17(b)); Allen R. Stein, *Erie and Court Access*, 100 YALE L.R. 1935, 1998-2000 (1991) (arguing corporation that cannot seek redress in state forum should not be able to sue in federal forum under Rule 17(b) because state has interests in enforcing business qualification requirements).

⁷⁷⁹ See Clark 3, *supra* note 5, at 269.

⁷⁸⁰ See, e.g., Ely, *supra* note 1, at 727-28.

The Supreme Court visited Rule 17(b) by name in *Van Dusen v. Barrack*,⁷⁸¹ although only promiscuously intertwined with section 1404(a). Recall that Barrack commenced a wrongful death action in her capacity as administratrix of her decedent's estate.⁷⁸² She had qualified as administratrix in Pennsylvania, the state in which the federal court of commencement sat.⁷⁸³ However, Eastern Airlines proposed transfer of the case under 28 U.S.C. § 1404(a), to the United States District Court in Massachusetts, a state in which she had no authority to proceed as administratrix.⁷⁸⁴ What rule of decision about Barrack's capacity to sue controlled in the United States District Court for the District of Massachusetts? Rule 17(b), which is older than § 1404(a) and has not been changed states, "[t]he capacity [to sue or be sued] of an individual . . . acting in a representative capacity . . . shall be determined by the law of the state in which the district court is held."⁷⁸⁵ But which was "the state in which the district court is held,"⁷⁸⁶ the court of commencement (i.e., the transferor court) or the court of disposition (i.e., the transferee court)? Rule 17(b) does not say. In a world without transfer statutes, "the state in which the district court is held"⁷⁸⁷ means, without saying so, the court of commencement *and* disposition. In *Van Dusen*, the Supreme Court held "the state in which the district court is held" to mean Pennsylvania,⁷⁸⁸ thus making the United States District Court for the District of Massachusetts a court in which the action could have been brought and authorizing Barrack to act as her decedent's administratrix there, whether the state of Massachusetts liked it or not. Rule 17(b)'s reference, said Justice Goldberg,

to the State "in which the district court is held" was intended

⁷⁸¹ 376 U.S. 612 (1964).

⁷⁸² *Van Dusen*, 376 U.S. at 641; *see supra* pp. 282-84.

⁷⁸³ *Van Dusen*, 376 U.S. at 641.

⁷⁸⁴ *Id.*

⁷⁸⁵ FED. R. CIV. P. 17(b).

⁷⁸⁶ *Id.*

⁷⁸⁷ *Id.*

⁷⁸⁸ *Van Dusen*, 376 U.S. at 640-43.

to achieve the same basic uniformity between state and federal courts as was intended by the decisions which have formulated the *Erie* policy in terms of requiring federal courts to apply the laws of the States "in which they sit."⁷⁸⁹

The plaintiff's argument, he went on,

assumes, incorrectly we think, that the critical phrase—"in which the district court is held"—carries a plain meaning which governs even in the case of a § 1404(a) transfer involving two district courts sitting in different States.⁷⁹⁰

He stated that both Rule 17(b) and *Erie*, antedating section 1404(a) as they did, spoke without anticipating the choice-of-law consequences of transfers between districts lying in different states.⁷⁹¹ From these, he inferred:

that Rule 17(b) was intended to work an accommodation of interests within our federal system and that in interpreting it in new contexts we should look to its guiding policy and keep it "free from entanglements with analytical or terminological niceties."⁷⁹²

Since in this case, he concluded,

the transferee district court must *under section 1404(a)* apply the laws of the State of the transferor district court, . . . Rule 17(b) must be interpreted similarly so that the capacity to sue will also be governed by the laws of the transferor State.⁷⁹³

From the line of reasoning suggested by these excerpts, the Court seems to have thought its chosen definition of "the state in which the district court is held" *required* by Rule 17(b) and section 1404(a) or by both when read together. As suggested earlier, however, section 1404(a) arguably exhausted its role by setting the stage upon which Rule 17(b)'s words "the state in

⁷⁸⁹ *Id.* at 642.

⁷⁹⁰ *Id.*

⁷⁹¹ *Id.*

⁷⁹² *Id.*

⁷⁹³ *Van Dusen*, 376 U.S. at 642 (emphasis added).

which the district court is held" no longer bore one clearly incontestable meaning.⁷⁹⁴ Viewed in this way, Rule 17(b) actually *provided* the rule of decision that made section 1404(a)'s application straightforward.

7) *Rules 23 and 23.1 of the Federal Rules of Civil Procedure*⁷⁹⁵

Both *Cohen v. Beneficial Industrial Loan Corp.*⁷⁹⁶ and *Kamen v. Kemper Financial Services, Inc.*⁷⁹⁷ afforded the Justices opportunities to consider section 1652's mandate in the context of stockholders' derivative suits. At *Cohen*'s earlier date, Rule 23 governed both class actions generally and stockholders' derivative suits. By the time *Kamen* arose, stockholders' derivative suits had their own rule, Rule 23.1.

In *Cohen*, one can see some use made of the *provide-or-require* calculus, if not by name and in pure form, at least in substantial effect. *Cohen* commenced his stockholders' derivative suit against Beneficial in the United States District Court for the District of New Jersey.⁷⁹⁸ Sometime thereafter, New Jersey passed a statute requiring a stockholder plaintiff with a stake as small as *Cohen*'s to give security for reasonable expenses including attorney fees and making him liable for the same should he fail to prevail on the merits of his suit.⁷⁹⁹ The district court refused to require security.⁸⁰⁰ On petition for writ of mandamus, the United States Court of Appeals for the Third Circuit reversed.⁸⁰¹ On writ of certiorari, the Supreme Court affirmed.⁸⁰² The eyes of both the majority and the dissenters fell upon Rule 23 of the Federal Rules of Civil Proce-

⁷⁹⁴ See *supra* pp. 282-84.

⁷⁹⁵ FED. R. CIV. P. 23; FED. R. CIV. P. 23.1.

⁷⁹⁶ 337 U.S. 541 (1949).

⁷⁹⁷ 500 U.S. 90 (1991).

⁷⁹⁸ *Cohen*, 337 U.S. at 543.

⁷⁹⁹ *Id.* at 544-45.

⁸⁰⁰ *Id.* at 545.

⁸⁰¹ *Id.*

⁸⁰² *Id.* at 557.

dure.⁸⁰³ The majority concluded that Federal Rule 23 did not cover the matter of security and, therefore, that the New Jersey statute controlled.⁸⁰⁴ The majority opinion reasoned as follows:

These provisions [of Rule 23] neither create nor exempt from liabilities, but require complete disclosure to the court and notice to the parties in interest. None conflict with the statute in question and all may be observed by a federal court, even if not applicable in state court.⁸⁰⁵

Three dissenters concluded that Federal Rule 23, in effect, preempted the field.⁸⁰⁶ However, both the majority and the dissenters also invoked "erieandtompinkinated" reasoning.⁸⁰⁷ The majority cited section 1652 but also invoked *Erie*, saying:

[The Court] held that judicial decisions are laws of the states within its [section 1652's] meaning. But *Erie R. Co. v. Tompkins* and its progeny have wrought a more far-reaching change in the relation of state and federal courts and the application of state law in the latter whereby in diversity cases the federal court administers the state system of law in all except details related to its own conduct of business. . . . The only substantial argument that this New Jersey statute is not applicable here is that its provisions are mere rules of procedure rather than rules of substantive law.⁸⁰⁸

The majority went on to conclude that the New Jersey statute's provisions were not "mere rules of procedure," saying:

[The statute] creates a new liability where none existed before, for it makes a stockholder who institutes a derivative action liable for the expense to which he puts the corporation and other defendants, if he does not make good his claims. Such liability is not usual and it goes beyond payment of

⁸⁰³ *Cohen*, 337 U.S. at 556-57.

⁸⁰⁴ *Id.*

⁸⁰⁵ *Id.* at 556.

⁸⁰⁶ *Id.* at 557.

⁸⁰⁷ *Id.* at 555, 561.

⁸⁰⁸ *Cohen*, 337 U.S. at 555.

what we know as "costs" [including, as it did, attorney fees]. If all the Act did was to create this liability, it would clearly be substantive.⁸⁰⁹

It concluded that securing the realization of this new right by a provision requiring a bond did not make of the statute "a mere procedural device."⁸¹⁰

To his otherwise straightforward reliance upon Rule 23, one of the dissenters, Justice Rutledge, added an argument conceding the procedure-substance distinction to be controlling, but insisting that procedure "having a substantive tinge" was still procedure,⁸¹¹ and concluding:

[The provisions of the New Jersey statute] are too closely related to the modes and methods of conducting litigation in the federal courts to be capable of displacing Congress' power or regulation in those respects or the federal courts' power to hear and determine the respective controversies.⁸¹²

In reasoning thus, Justice Rutledge arguably implied a "choose federal law, if . . . ; state law, if not" interpretation of section 1652's mandate.⁸¹³

In *Kamen v. Kemper Financial Services, Inc.*,⁸¹⁴ the plaintiff commenced her stockholders' derivative suit in the United States District Court for the Northern District of Illinois on behalf of the Cash Equivalent Fund, Inc. ("the Fund"), against Kemper Financial Services, Inc., the Fund's investment advisor.⁸¹⁵ In her complaint, she alleged "that she made no precomplaint demand on the Fund's board of directors because doing so would have been futile."⁸¹⁶ Upon Kemper's motion, the district court dismissed Kamen's suit "on the ground that [she] had failed to plead the facts excusing demand with suffi-

⁸⁰⁹ *Id.* at 555-56.

⁸¹⁰ *Id.* at 556.

⁸¹¹ *Id.* at 559-61.

⁸¹² *Id.* at 561.

⁸¹³ *See supra* p. 175.

⁸¹⁴ 500 U.S. 90 (1991).

⁸¹⁵ *Kamen*, 500 U.S. at 92.

⁸¹⁶ *Id.*

cient particularity for purposes of Federal Rule of Civil Procedure 23.1.⁸¹⁷ The United States Court of Appeals for the Seventh Circuit affirmed the dismissal, but on a more ambitious ground.⁸¹⁸ "[A]dopt[ing] as a rule of federal common law the ALI's so-called 'universal demand' rule, under which the futility exception [to the demand requirement] is abolished," the Court of Appeals held Kamen's conceded "failure to make a precomplaint demand . . . fatal to her case."⁸¹⁹ On writ of certiorari, the Supreme Court reversed.⁸²⁰ Considering first Rule 23.1's role in the case before it, the Court held it not broad enough to provide the rule of decision needed in the case at hand.⁸²¹ Said Justice Marshall:

[A]lthough Rule 23.1 clearly contemplates both the demand requirement and the possibility that demand may be excused, it does not *create* [i.e., *provide*] a demand requirement of any particular dimension. On its face, Rule 23.1 speaks only to the adequacy of the shareholder representative's pleadings. *Indeed, as a rule of procedure issued pursuant to the Rules Enabling Act, Rule 23.1 cannot be understood to "abridge, enlarge or modify any substantive right."* . . . [T]he function of the demand doctrine in delimiting the respective powers of the individual shareholder and of the directors to control corporate litigation clearly is a matter of "substance," not "procedure."⁸²²

The opinion then proceeded to its principal holding that the lower courts should have looked to the law of the state of Maryland, the state of the Fund's incorporation.⁸²³

⁸¹⁷ *Id.*

⁸¹⁸ *Id.*

⁸¹⁹ *Id.*

⁸²⁰ *Kamen*, 500 U.S. at 95.

⁸²¹ *Id.* at 96-97.

⁸²² *Id.* at 96-97 (emphasis of "contemplates" and "create" in original; other emphasis added).

⁸²³ *See supra* pp. 278-80.

8) *Rule 35 of the Federal Rules of Civil Procedure*⁸²⁴

In 1941, Rule 35(a) read, in pertinent part, as follows: "In an action in which the mental or physical condition of a party is in controversy, the court in which the action is pending may order him to submit to a physical or mental examination by a physician."⁸²⁵

In *Sibbach v. Wilson & Co.*,⁸²⁶ Sibbach sued Wilson & Company in United States District Court for the Northern District of Illinois to recover damages for personal injuries sustained in Indiana.⁸²⁷ Upon Wilson & Company's motion, the district court ordered Sibbach to submit to a physical examination under Rule 35 of the Federal Rules of Civil Procedure.⁸²⁸ Indiana state law authorized such an order.⁸²⁹ Illinois state law did not.⁸³⁰ Sibbach refused to comply, contending that, insofar as Rule 35 authorized the order requiring her to submit to a physical examination, it exceeded the rulemaking authority delegated to the United States Supreme Court by Congress.⁸³¹ The district court adjudged Sibbach in contempt.⁸³² The United States Court of Appeals for the Seventh Circuit affirmed.⁸³³ On writ of certiorari, the Supreme Court reversed the adjudication of contempt but upheld the applicability and validity of Rule 35.⁸³⁴ Although Justice Roberts cited the Rules of Decision Act (then title 28, section 725) he saw himself applying the Rules Enabling Act *instead* of the Rules of Decision Act, not *through* it.⁸³⁵ Nevertheless, the decision has a place in *provide-or-require* analysis, because it recognized and articulated the two-step inquiry necessary to con-

⁸²⁴ FED. R. CIV. P. 35.

⁸²⁵ *Id.*

⁸²⁶ 312 U.S. 1 (1941).

⁸²⁷ *Sibbach*, 312 U.S. at 16.

⁸²⁸ *Id.* at 6.

⁸²⁹ *Id.* at 7.

⁸³⁰ *Id.*

⁸³¹ *Id.*

⁸³² *Sibbach*, 312 U.S. at 7.

⁸³³ *Id.*

⁸³⁴ *Id.*

⁸³⁵ *Id.* at 10-11.

firm the validity of a rule of decision laid down under an enabling statute. As to the first step, that is, Congress's constitutional authority to enact a statute enabling the promulgation of a rule like the one at issue, the opinion said, "Congress has undoubted power to regulate the practice and procedure of federal courts, and may exercise that power by delegating to this or other federal courts authority to make rules"⁸³⁶ As to the second, that is, whether Congress actually authorized the making of a rule like the one at issue, the opinion reasoned that Rule 35 did not transgress the enabling act's interdiction of a rule that abridged, enlarged, or modified substantive rights.⁸³⁷

9) *Rule 59(a) of the Federal Rules of Civil Procedure*⁸³⁸

In pertinent part, Rule 59(a) provides: "A new trial may be granted to all or any of the parties on all or part of the issues (1) in an action in which there has been a trial by jury, for any of the reasons for which new trials have heretofore been granted in actions at law in the courts of the United States"⁸³⁹

Recall the majority's translated holding in *Gasperini v. Center for Humanities, Inc.*⁸⁴⁰ The Seventh Amendment's second clause ("no fact . . . otherwise re-examined") required federal appellate courts to apply the federally established scope of review for district court decisions about the excessiveness of jury verdicts, but the Seventh Amendment's first clause ("right of trial by jury . . . preserved") did not require federal district courts to apply the federally established standard for determining excessiveness. In a dissenting opinion endorsed by Chief Justice Rehnquist and Justice Thomas, Justice Scalia disagreed that a United States district court must apply New York's statutory standard.⁸⁴¹ He vouched to warranty Rule 59(a)'s

⁸³⁶ *Id.* at 9.

⁸³⁷ *Sibbach*, 312 U.S. at 10-14.

⁸³⁸ FED. R. CIV. P. 59(a).

⁸³⁹ *Id.*

⁸⁴⁰ 518 U.S. 415 (1996). *See supra* pp. 254-56.

⁸⁴¹ *Gasperini*, 518 U.S. at 462-69 (Scalia, J., dissenting).

provision that United States district courts could grant new trials in jury-tried actions "for any of the reasons for which new trials have heretofore been granted in actions at law *in the courts of the United States*,"⁸⁴² invoking, at least by implication, his readers' understanding that a United States district court would *not* "heretofore" have granted a new trial under the facts of *Gasperini*. Justice Scalia's opinion speaks the language of *provide-or-require* exegesis with scant need for interpretation: Section 1652 directs us to Federal Rule 59(a), which *requires* as its rule of decision the standard for measuring excessiveness "heretofore [applied] in the courts of the United States."⁸⁴³ If not persuaded to change its mind had it considered the proposition thus starkly presented, the majority's only response in kind, it would seem, would have been that *Erie*'s "twin aims," that is (in my translation), protecting the principles of parcelled power and equal protection, required it to read Rule 59(a)'s scope more restrictively than did the three dissenters. That would have posed a challenge, because Rule 59(a)'s language covers the field more explicitly, it seems, than did Appellate Rule 38's language in *Burlington Northern*.

10) *Rule 38 of the Federal Rules of Appellate Procedure*⁸⁴⁴

Title 28, section 2072 (the Rules Enabling Act in its present incarnation) provides the authority not only for the Federal Rules of Civil Procedure, but for the Federal Rules of Appellate Procedure as well.⁸⁴⁵ The Court has taken one opportunity to integrate these latter rules into the scheme mandated by section 1652. The apparent clash of a state rule of decision with Rule 38 of the Federal Rules of Appellate Procedure afforded the opportunity. Rule 38 provided: "If a court of appeals shall determine that an appeal is frivolous, it may award just damages and single or double costs to the appellee."⁸⁴⁶

⁸⁴² *Id.* at 467-68 (Scalia, J., dissenting) (emphasis in original).

⁸⁴³ *Id.*

⁸⁴⁴ FED. R. APP. P. 38.

⁸⁴⁵ 28 U.S.C. § 2072 (1994).

⁸⁴⁶ FED. R. APP. P. 38.

In *Burlington Northern Railroad v. Woods*,⁸⁴⁷ the opinion cited *Erie* and *Hanna*, but not section 1652. Nevertheless, it invoked *provide-or-require* reasoning in all but name.⁸⁴⁸ The plaintiffs commenced their tort action in an Alabama state court.⁸⁴⁹ The defendant removed it to the United States District Court for the Northern District of Alabama.⁸⁵⁰ The district court rendered judgment for the plaintiffs.⁸⁵¹ The defendant appealed, posting bond to stay execution of the judgment pending appeal.⁸⁵² The United States Court of Appeals for the Eleventh Circuit affirmed without modification, granting the plaintiffs' motion to recover the mandatory penalty imposed by an Alabama statute upon an unsuccessful appellant who has stayed a judgment pending appeal by posting bond.⁸⁵³ On writ of certiorari, the Justices reversed that part of the judgment awarding the penalty, holding that Rule 38 of the Federal Rules of Appellate Procedure occupied the field and preempted application of the state statute.⁸⁵⁴ Justice Marshall wrote:

Rule 38 affords a court of appeals plenary discretion to assess "just damages" in order to penalize an appellant who takes a frivolous appeal and to compensate the injured appellee for the delay and added expense of defending the district court's judgment. Thus, the Rule's discretionary mode of operation unmistakably conflicts with the mandatory provision of Alabama's affirmance penalty statute.⁸⁵⁵

Moreover, he added:

The purposes underlying the Rule are sufficiently coextensive with the asserted purposes of the Alabama statute to indicate that the Rule occupies the statute's field of operation so as to

⁸⁴⁷ 480 U.S. 1 (1987).

⁸⁴⁸ *Woods*, 480 U.S. at 2.

⁸⁴⁹ *Id.*

⁸⁵⁰ *Id.*

⁸⁵¹ *Id.*

⁸⁵² *Id.*

⁸⁵³ *Woods*, 480 U.S. at 3.

⁸⁵⁴ *Id.* at 7.

⁸⁵⁵ *Id.*

preclude its application in federal diversity actions. . . . Federal Rule 38 adopts a case-by-case approach to identifying and deterring frivolous appeals; the Alabama statute precludes any exercise of discretion within its scope of operation.⁸⁵⁶

Addressing the Rule's validity under section 2072, Justice Marshall said:

Federal Rule 38 regulates matters which can reasonably be classified as procedural, thereby satisfying the constitutional standard for validity. Its displacement of the Alabama statute also satisfies the statutory constraints of the Rules Enabling Act. The choice made by the drafters of the Federal Rules in favor of a discretionary procedure affects only the process of enforcing litigants' rights and not the rights themselves.⁸⁵⁷

In reprise, resting on constitutionally and statutorily solid ground, Rule 38 *required* (although it did not *provide*) a rule of decision overriding the rule of decision provided by the Alabama statute.⁸⁵⁸

4. *Rules of Decision Embodied in "Wholly Judge-Made" Rules of Practice and Procedure*

Whether under an *Erie* regime, a *provide-or-require* regime, or probably any other regime, "procedural" rules not obviously traceable to discrete statutory provisions, otherwise loosely called "common law procedural rules" or, more carefully, "wholly judge-made"⁸⁵⁹ rules, throw down the toughest challenges. Consider, for example, rules about the permissible limits imposed upon counsels' closing jury arguments.⁸⁶⁰ Absent some federal statute or statutorily enabled rule specifically *providing* such limits, a search for federally enacted texts indi-

⁸⁵⁶ *Id.* at 7-8.

⁸⁵⁷ *Id.* at 8.

⁸⁵⁸ *Woods*, 480 U.S. at 8.

⁸⁵⁹ Ely, *supra* note 1 at 698.

⁸⁶⁰ See *Johnson v. Colglazier*, 348 F.2d 425 (5th Cir. 1965). Thanks for the cite to Redish & Phillips, *supra* note 5, at 389; see also *Chambers v. NASCO, Inc.*, 501 U.S. 32, 55-58 (1991); *supra* pp. 281-82 (discussing attorney sanctions for bad faith conduct in court room).

cated by section 1652 comes down to finding statutory and/or constitutional sources which, taken as a whole, *require* one rule or another or, at least, a rule from one source or another. The Seventh Amendment (right to trial by jury), 28 U.S.C. section 132(a) (creating the United States district courts), 28 U.S.C. section 1332 (establishing diversity jurisdiction), and 28 U.S.C. section 2072 (the Rules Enabling Act) come to mind. The trial court's control over what the jury hears constitutes an incident of the jury trial preserved by the Seventh Amendment. Creating a court implies that court's inherent authority to apply *some* rule of decision to every question arising during the course of a judicial proceeding. Establishing diversity jurisdiction and authorizing a single set of procedural rules applicable in all district courts imply a policy of horizontal uniformity. The policy of horizontal uniformity *requires* rules drawn from a source common to all district courts or, at least, to all district courts in a federal circuit. *Provide-or-require* reasoning about the choice of other "wholly judge-made" rules of practice or procedure would, at least in most cases, one supposes, follow substantially this same train of thought.

III. CONCLUSION

I will stop now. Not because this is *the* place to stop or even *a good* place to stop, but because I have to stop somewhere. A two-page proposal first offered to my civil procedure students in the fall of 1997 as an alternative aid to understanding what lies behind "Erie doctrine" shows every intention of becoming an encyclopedia. Other volumes must await other occasions, perhaps other authors.

If nothing else, this inquiry has been an exercise in "what if?," a thought experiment about alternative histories. That may be all it will or ought ever come to. For those of us who have a professional lifetime invested in the *Erie* priesthood, it may seem less painful to fight than to switch.⁸⁶¹ Still, unborn

⁸⁶¹ I expect future work to show that much of the secondary literature fits comfortably into the *provide-or-require* calculus.

generations of law students, not to mention lawyers and judges, might thank us for the sacrifice.

And what if Court or Congress took it seriously? A freshly contemporary understanding of section 1652 and its potentially central position in 21st-century federalism might at least support a judicial integration of what we have heretofore known as "Erie doctrine" with concepts of "federal common law" and preemption. It might even move Congress to re-enact section 1652 in words not encumbered by ancient understandings.⁸⁶²

On the other hand, there is precedent and Congress's recent experience with 28 U.S.C. § 1367 (the supplemental jurisdiction statute). Better to consort with the evil we know than to court an evil we know not. I have left enough loose ends to make this conservative caution attractive. I presently suppose, but do not yet know, that a back-to-the-statute *provide-or-require* approach to sources of law for federal courts will produce sounder decisions at less cost and with less legalistic mystique than does the present dogma. The supplemental jurisdiction statute, still painfully fresh in mind, cautions against hubris. Much may remain to learn from the history and jurisprudence of the cases and commentary.⁸⁶³ Voices remain to be heard. Even an occasional sally from the ivory tower might not hurt.⁸⁶⁴

⁸⁶² See *supra* note 19 and accompanying text.

⁸⁶³ What I said earlier about sampling problems applies to secondary sources as well as primary. See text at pp. 191 and 192, above. As for the caselaw, I have so far concentrated on decisions issued in the name of the United States Supreme Court. A surprise or so, happy or unhappy, may well lurk in the lower federal court decisions.

⁸⁶⁴ See, e.g., Kurland, *supra* note 5, at 199 ("[T]he difference of vantage points continues to make the problem as simple for the cloistered professors as it is difficult for the jurists.").

ADVERTISEMENTS AND SPONSORSHIPS IN CHARITABLE CYBERSPACE: VIRTUAL REALITY MEETS LEGAL FICTION

*Darryll K. Jones**

I. INTRODUCTION

By now, it is perhaps cliché to quote Sir Walter Scott's familiar refrain¹ when referring to communications occurring via the World Wide Web (the Web).² And yet, that age-old wisdom comes readily to mind when one considers the unrelated business income tax (UBIT)³ as it relates to charities that, for consideration paid, participate in a profit-seeker's web-based marketing communications. That first lie, to be precise, is that a charity's payment-induced, unlimited public display of a profit-seeker's logo, slogan and product, when unaccompanied by "comparative or qualitative descriptions" or explicit requests to buy, results in no trade or business income for purposes of UBIT.⁴ Thus, the Orange Bowl Committee⁵ is

* Assistant Professor of Law, University of Pittsburgh School of Law.

¹ "Oh what a tangled web we weave, when first we practise to deceive!" Sir Walter Scott, *LAY OF THE LAST MINSTREL*, Canto vi. Stanza 17, in *THE COMPLETE WORKS OF SCOTT* 71 (Horace E. Scodder ed., 1920).

² References to Sir Walter Scott's "tangled web" in conjunction with discussions of the World Wide Web abound in the legal literature. See, e.g., Shelby Clark, Note, "What a Tangled Web We Weave, When First We Practice To Deceive": *Frames, Hyperlinks, Metatags, and Unfair Competition on The World Wide Web*, 50 *HASTINGS L.J.* 1333 (1999); Brian I. Simon, Note and Comment, *The Tangled Web We Weave: The Internet and Standing Under the Fourth Amendment*, 21 *NOVA L. REV.* 941 (1997); Robert A. Bourque & Kerry L. Konrad, *The Tangled Web: First Wave of Internet Cases Provides More Questions Than Answers*, 8 *J. PROPRIETARY RTS.* 2 (1996).

³ The UBIT is the subject of 26 U.S.C. §§ 511-14 (1984). Hereinafter, citations to the Internal Revenue Code will be I.R.C. and all references thereto are to the Internal Revenue Code of 1984 as amended to date.

⁴ The idea that income derived in exchange for a charity's public acknowl-

not selling anything when, upon receipt of value, it renames its football game from "The Orange Bowl," to "The FedEx Orange Bowl," and then incessantly repeats that name in its media, including its official Website.⁶ And now, as that lie is unloosed in Cyberspace,⁷ it looks as though it will undergo a period of growth at least as intense and exponential as the growth of the Web itself.⁸ Indeed, to avoid exposure of the

edgment of a profit-seeker's payment thereof is exempt from taxation, while revenues derived from a charity's paid provision of advertising space to the same profit-seeker is taxable, was first officially announced in Proposed Treasury Regulation § 1.513-4, 58 Fed. Reg. 5687 (1993). The quoted phrase is taken from the proposed regulations. Prop. Treas. Reg. § 1.513-4, 58 Fed. Reg. 5687 (1993).

⁵ The Orange Bowl Committee, Inc. is tax exempt under I.R.C. § 501(c)(3). See Internal Revenue Service, EXEMPT ORGANIZATIONS MASTER LIST (2000).

⁶ The Orange Bowl Committee's web site is at <<http://www.orangebowl.org/main.asp>> (visited Oct. 11, 2000). FedEx, a 19 billion dollar for-profit corporation, became The Orange Bowl Committee's title sponsor in 1989. See <<http://www.Fedex.com/us/sports/orangebowl/fedexorangebowl/index.html>> (visited Oct. 11, 2000); see also <<http://www.swbellcottonbowl.com>> (visited Nov. 17, 2000 (web site for Southwestern Bell Cotton Bowl)); <<http://www.tostitos.fiestabowl.com>> (visited Nov. 17, 2000) (web site for Tostitos Fiesta Bowl).

⁷ The term "Cyberspace" was first used by the science fiction novelist and short story writer, William Gibson, who also described a computer realm—a virtual reality—in which humans could interact for business or pleasure. WILLIAM GIBSON, *NEUROMANCER* 51 (1984).

⁸ In *Reno v. American Civil Liberties Union*, the Court noted the "extraordinary growth" of the Internet:

The number of "host" computers—those that store information and relay communications—increased from about 300 in 1981 to approximately 9,400,000 by . . . 1996. Roughly 60% of these hosts are located in the United States. About 40 million people used the Internet at the time of trial, a number that is expected to mushroom to 200 million by 1999.

521 U.S. 844, 850 (1997). Of course, the Web represents only one part of the "Internet," a term which is technically meant to apply to all forms of electronic computer communication, including electronic mail and electronic bulletin boards. See generally Timothy Wu, *Essay: Application Centered Internet Analysis*, 85 VA. L. REV. 1163 (1999) (arguing that Internet is comprised of many applications in addition to world wide web and that single legal construct is inappropriate for various applications of Internet); Clark, *supra* note 2, at 1334 ("The Web, at its simplest, is a portion of the Internet characterized by hyperlinks."). The Web is growing so fast that estimates of its size (by reference to the number of users) are necessarily conservative. One e-commerce industry association puts the number of U.S. and Canadian adult Internet users at 92.2 million (up from 22 million in 1995). See CommerceNet, *Internet Population*, available at <<http://www.commerce.net/research/stats/wwwpop.html>> (visited Oct. 10, 2000). The same group estimates the

original lie, the law must weave ever more elaborate patterns of necessarily myopic rules having no relationship to the reality or virtual reality of marketing communications.⁹

The more fundamental legal fiction embodied in the distinction between a charity's sale of advertisement from its acknowledgment of sponsorships is that the latter is neither properly nor customarily considered conducive to a profit-seeker's marketing communication goals (i.e., to sell more goods or services).¹⁰ Therefore, a charitable media's receipt of

number of 1999 adult web users at 73.3 million (up from 14.3 million in 1995), indicating that the world wide web is becoming synonymous with the Internet, as some authors have noted. *Id.*; see also Haran C. Rashes, *The Impact of Telecommunication Competition and The Telecommunications Act of 1996 on Internet Service Providers*, 16 TEMP. ENVTL. L. & TECH. J. 49, 58 (1997). A report commissioned by the United States Department of Commerce states that "Internet traffic doubles every 100 days." U.S. DEPT OF COMMERCE, *THE EMERGING DIGITAL ECONOMY* 8 (1998), available at <<http://www.doc.gov/ecommerce/emerging.htm>> (visited Oct. 10, 2000). In light of such figures, estimates to the effect that by 2000 the world-wide Internet population will be approximately 150 million seem woefully conservative. See Kuen-Hee Ju-Pak, *Content dimensions of Web advertising: a cross-national comparison*, 18 INT'L J. ADVERTISING 207, 207 (1999) (stating that number of persons using Web worldwide will reach 150 million adults in 2000). In fact, the number of persons with access to the Internet grew to 304 million as of March 2000. United States Department of Commerce, *Digital Economy 2000* at 7 (2000), available at <<http://www.esa.doc.gov/de2000.pdf>> (visited Nov. 1, 2000).

⁹ The opening premise, for example, in the Internal Revenue Service's effort to distinguish between sponsorship and advertising on a charity's web site is this: a stationary banner can be a mere acknowledgement, but a moving banner is probably advertising. Cheryl Chasin et al., *Tax Exempt Organizations and World Wide Web Fundraising and Advertising on The Internet* in Internal Revenue Service, *EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TEXT FOR FY 2000* 120 (1999) (available via Westlaw at 1999 TNT 169-20, at 14-15 ("a link will retain the passive character associated with corporate sponsorship while a moving banner is more likely to be considered to be advertising."). In Part III, I show why this distinction is entirely over-simplistic and already overcome by technology and advertising science.

¹⁰ In Announcement 92-15, for example, the Service stated:

Payments an exempt organization receives from donors are nontaxable contributions where there is no expectation that the organization will provide a substantial return benefit. Mere recognition of a corporate contributor as a benefactor normally is incidental to the contribution and not of sufficient value to the contributor to constitute unrelated trade or business.

I.R.S. Announcement 92-15, 1992-5 I.R.B. 51. Certainly, the assertion has historical

cash or in-kind benefit in return for a public acknowledgment thereof does not unfairly deprive taxable media of revenue sources.¹¹ This is so, according to the implicit reasoning, because marketing communication purchased from taxable media is always explicit, never so subtle as to occur without an explicit call to action or qualitative inducement to buy the subject brand immediately.¹² Hence, charitable media is selling something altogether different from that being sold by taxable media. The underlying reasoning, though, assumes away the more likely and sophisticated occurrence of the coordinated, multi-media marketing campaign dependent in part on simple brand awareness but, nevertheless, eventually designed to elicit a consumer purchase response.¹³ The reason-

validity, as sponsorship was indeed once thought of as a purely philanthropic act, unmotivated by the hope of return benefit:

Earlier perceptions of sponsorship tended to regard it as in the donations category, with perhaps the primary beneficiary being the recipient. Commercialism in sponsorship exchanges was often lacking, with the sponsorship budget being administered in client companies by a public affairs or similar type of department which viewed such "giving" as part of its societal responsibility. Recipients viewed such sponsorship in philanthropic terms with little requirement to return commercial value.

Tony Meenaghan, *Current Developments & Future Directions in Sponsorship*, 17 INT'L. J. ADVERTISING 3, 10 (1998). In Part III, we see that the sponsorship is no longer a philanthropic or altruistic activity, if indeed it ever was, but is instead motivated entirely by the hope of profit.

¹¹ Unfairness would result from the violation of the fundamental tax notion of "horizontal equity"—the idea that similarly situated persons should be similarly taxed. See generally Louis Kaplow, *Horizontal Equity: Measures In Search of A Principle*, 42 NAT'L TAX J. 139 (1989). It is unfair to tax one entity that sells widgets if another entity selling the same widgets is exempt from tax.

¹² Compare Prop. Treas. Reg. § 1.513-4(b), 58 Fed. Reg. 5690 (1993) (defining advertising for purposes of UBIT) with Prop. Treas. Reg. § 1.513-4(c), 58 Fed. Reg. 5690 (1993) (defining sponsorship acknowledgments for purposes of UBIT).

¹³ One group of researchers state the point thusly:

Initially it is important to appreciate that sponsorship is merely one element of a wider communication mix and as such must be consistent with all the other components. Integration is therefore particularly relevant [reference omitted]. Essentially, each method of marketing communication assists in achieving the overall marketing communication objective.

Des Thwaites, Rafael Aguilar-Majarrez & Callum Kidd, 17 INT'L. J. ADVERTISING 29, 32-33 (1998).

ing instead seems based upon a most primitive, even Pavlovian¹⁴ view of marketing communication; one dominated by advertisement characterized solely by a profit-seeker's presentation of an explicit verbal or pictorial inducement (the advertising stimuli) in the context of media communication, followed by a consumer's immediately rushing to the store to buy the item which is the subject of the inducement (the conditioned purchase response).¹⁵ To the extent this view of marketing communication is false, so too is the distinction between sponsorship and advertising revenue.

Tax law, of course, is quintessentially an interdisciplinary science. The Internal Revenue Code (the Code) makes sense and, in individual instances, achieves its purpose only insofar as it takes into account the realities of the various contexts in which it is to apply.¹⁶ The purpose of the UBIT, as discussed

¹⁴ Through experimentation, the Russian physiologist, Ivan Pavlov, discovered the "conditioned reflex." See I.P. Pavlov, *The Conditioned Reflex*, in I.P. PAVLOV: SELECTED WORKS at 245, 248 (Foreign Languages Publishing House, 1955). Essentially, Pavlov showed that an animal could be trained to exhibit a certain physiological response appropriate to one stimulus—e.g., salivating in response to the placement of an acid into the dog's mouth—upon the occurrence of another stimulus which normally would not evoke the response—salivating solely in response to the ringing of a bell—if that second stimulus had previously been made to occur prior to every instance in which first, appropriate stimulus occurred. *Id.*

¹⁵ The Service's approach to advertising, particularly via the Web, is Pavlovian to the extent that it rests upon the assumption that a user will not click on a stationary banner and thereby go to a for-profit's homepage containing explicit inducements and qualitative statements, but will be induced, perhaps involuntarily, to click on a blinking or moving banner. That seems to be the only logical premise underlying the Service's speculation that a blinking banner constitutes advertisement if the banner is linked to a for-profit's website containing explicit inducements or qualitative statements, but a non-blinking banner linked to the same site is not advertising. See Chasin et al., *supra* note 9.

¹⁶ Primarily for reasons related to the need for easy and uniform enforcement, the Code does not always conform precisely to the substantive knowledge of the field to which it relates. For example, income in the economic sense might be present even before an item of value is sold or otherwise exchanged. See HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938) (defining income to include untapped appreciation in property). But the law would be difficult to administer if, for example, gross income included the increase in the value of real property even before the property is sold. In such cases, the taxpayer might not have cash to pay the tax, and the government would be required to devise some way of measuring the increase, each and every year, of each and every taxpayer's property.

in Part II, is to eliminate a market distortion thought to occur when a tax-exempt entity is allowed to sell the same product or services available from a taxable entity.¹⁷ The basic premise is that a tax exempt entity can sell the identical product or service at a lesser price and thereby drive its taxable competitors out of the market because the exempt entity's costs are less than a taxable entity's cost by an amount equal to the foregone tax.¹⁸ Thus, the UBIT scheme achieves its

A tax code definition of income that coincided with an economic definition of income would therefore be administratively unworkable. As a result, the code treats income as occurring only upon the happening of a "realization event." I.R.C. § 1001 (2000); see *Cottage Savs. Ass'n v. Commissioner*, 499 U.S. 554, 559 (1991) ("Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer 'realizes' the gain or loss."). In pronouncing a distinction between nontaxable sponsor acknowledgements and taxable advertisements, the Service noted that its distinction was in some respects inconsistent with the reality of marketing communications:

The principle of administrative simplicity governs the rules defining advertising and acknowledgements in the proposed regulations. As a result, the lines drawn between activities constituting advertising and acknowledgements may not relate to the substance of the activities. For example, distribution of samples of a sponsor's product to the general public at a sponsored event is substantively an inducement to buy the sponsor's product and, therefore, advertising. However, the proposed regulations provide that distribution of samples of a sponsor's product constitutes acknowledgment rather than advertising.

58 Fed. Reg. 5688 (1993). But unlike the administrative difficulty giving rise to the "realization" requirement, there seems nothing so difficult about treating a profit-seeker's distribution of free samples as advertising.

¹⁷ See generally Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined For Charity: Forty-Six Years Later*, 3 FLA. TAX REV. 367, 385-93 (1996) (describing and analyzing unfair competition concerns leading to enactment of UBIT); Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 614-621 (1989) (discussing several types of market inefficiencies that would result in absence of UBIT); Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982) (acknowledging unfair business rationale, but disputing its validity from economic standpoint).

¹⁸ "[Tax exemption] creates the potential for nonprofit organizations to compete unfairly with the private sector by using the absence of tax payments as a vehicle for charging a lower price than for-profit providers of identical or similar services (taxes being a cost of production that must be paid by taxable entities in the private sector)." Dennis Zimmerman, *Corporate Title Sponsorship Payments To*

purpose with respect to advertising by taxing advertising revenues derived by charitable media.¹⁹ In doing so, the Code purports to eliminate an unintended market distortion—the incentive for purchasers of advertising space to favor less costly charitable media over taxable media. To be thorough, Part II begins by showing that the whole premise of the UBIT is probably incorrect. The feared result, charitable monopolization of whole industries, is highly unlikely in the real world and even more unlikely in Cyberspace.

For the sake of argument, Part III assumes the legitimacy of the concerns motivating the UBIT scheme and then explains how UBIT came to be applied to advertisements appearing in charitable media, as well as the sorry history regarding the distinction between advertising and sponsorship revenues. The Internal Revenue Service (the Service), in a commendable demonstration of intellectual honesty, once concluded that sponsorship revenue was indeed no different than any other form of advertising revenue and should therefore be subject to taxation.²⁰ There were essentially two problems with the Service's pronouncement, one substantive and the other procedural, though neither undermined the correctness of the conclusion. As a substantive matter, the Service's conclusion was largely intuitive and therefore subject to easy and, indeed, unprincipled refutation.²¹ As a procedural matter, the Service's conclusion was made with regard to a college

Nonprofit College Football Bowl Games: Should They be Taxed?, Congressional Research Service Report No. 92-157E (1992) (available via Westlaw at 92 TNT 41-18).

¹⁹ I.R.C. § 513(c); Treas. Reg. § 1.512(a)-1(d)(1); Treas. Reg. § 1.513-1(d)(iv), Examples 3-7.

²⁰ Tech. Adv. Mem. 91-47-007 (Aug. 16, 1991). The facts and analysis of the Service's initial ruling are discussed in greater detail in Part III. See *infra* notes 78-81 and accompanying text.

²¹ Cynthia G. Farbman, *Forced To Be a Fan: An Analysis and History of the IRS's Proposed Regulations Regarding Corporate Sponsorship*, 2 SPORTS LAW. J. 53, 60-61 (1995) (discussing one exempt organization's attack on Service's actions because of "startling absence" of economic analysis); Paul Steckfus, *Proposed Corporate Sponsorship Regulations*, 7 EXEMPT ORG. TAX REV. 379, 379 (1993) (referring to arguments in response to Service's pronouncement in TAM 9147007 (which arguments eventually prevailed) as "patently ridiculous" and "false.").

football bowl game happening, as such games traditionally do, in the midst of the Christmas holiday season.²² One might speculate that the great "hue and cry"²³ in response to the Service's conclusion could not have been greater had the Service proposed to tax the celebration of Christmas itself.²⁴ In any event, the Service's omission of any empirical support for its conclusion, coupled with its impolitic unveiling of that conclusion with regard to a well-beloved event occurring during the most beloved of times, resulted in such an uproar that the Service mounted what can only be described as a hasty retreat. It quickly issued proposed regulations (the original proposed regulations)²⁵ stating that sponsorship was in fact different from advertisement, and revenues generated thereby would not be subject to taxation after all.²⁶ The Service never finalized the original proposed regulations²⁷ but its retreat

²² The "Southwestern Bell Cotton Bowl" is played on New Year's Day in Dallas, Texas. See <<http://www.swbellcottonbowl.com>> (visited Nov. 17, 2000).

²³ Paul Streckful, *IRS' Pre-Inaugural Gift For Charities*, 7 EXEMPT ORG. TAX. REV. 179, 179 (1993). (referring to firestorm of criticism from charities and national media as "the hue and cry").

²⁴ "College football inspires strong feelings in the United States. Although baseball may be the national pastime, it is college football bowl games we associate with Homecoming, New Year's Day celebrations, holidays spent with families and cold November days shared with close friends." Elizabeth M. Roberts, Note, *Presented To You By . . . : Corporate Sponsorship and The UBIT*, 17 VA. TAX REV. 399, 414 (1997).

²⁵ Prop. Treas. Reg. § 1.513-4, 58 Fed. Reg. 5687 (1983). (hereinafter referred to as the "original proposed regulations"). Soon after it released TAM 9147007, the Service published and requested public comment on formal guidelines designed for field agents conducting audits of charitable organizations regarding the receipt of sponsorship revenues (the audit guidelines). See I.R.S. Announcement 92-15, 1992-5 I.R.B. 51. The TAM and the audit guidelines were met with near universal condemnation. Roberts, *supra* note 24, at 406-09; Nathan Wirtschafter, Note and Comment, *Fourth Quarter Choke: How the IRS Blew the Corporate Sponsorship Game*, 27 LOY. L.A. L. REV. 1465, 1487-96 (1994). The Service then quickly issued the original proposed guidelines in hopes of undercutting the motivations for imminent Congressional action designed to overturn the TAM and audit guidelines. Farbman, *supra* note 21, at 67.

²⁶ For a timeline and discussion of the Service's issuance of TAM 9147007 and its issuance of the original proposed regulations, see Wirtschafter, *supra* note 25.

²⁷ In fact, the original proposed regulations were withdrawn and replaced by a second set of regulations, referred to in the text below as "the revised proposed regulations." See *Withdrawal of Previous Proposed Rules, Notice of Proposed*

was made permanent when Congress enacted I.R.C. § 513(i), essentially codifying the original proposed regulations.²⁸

Since enactment of I.R.C. § 513(i) the Service has continued a rear guard effort to maintain at least a semblance of fidelity to the goal of the UBIT as it relates to marketing communications.²⁹ Part III continues by describing the Service's latest proposal (the revised proposed regulations)³⁰ by which

Rulemaking and Notice of Public Hearing, 67 Fed. Reg. 11012 (Mar. 1, 2000) [hereinafter *Notice of Proposed Rulemaking*].

²⁸ I.R.C. § 513(i) exempts "qualified sponsorship payments" from taxation under the UBIT scheme. The provision distinguishes between sponsorship and advertisement in the same manner as did the Service in its proposed regulations:

[t]he term "qualified sponsorship" payment means any payment made by any person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgement of the name or logo (or product lines) of such person's trade or business in connection with the activities of the organization that receives such payment. Such a use or acknowledgement does not include advertising such person's products or services (including messages containing qualitative or comparative language, price information, or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use such products or services).

I.R.C. § 513(i)(2)(A) (2001).

²⁹ Many commentators viewed the Service's issuance of the original proposed regulations as evidence that the Service had capitulated to the selfish interests of exempt organizations that cared nothing for tax policy but sought only to continue enjoying a pot of tax free revenue. See David A. Brennan, *The Proposed Corporate Sponsorship Regulations: Is The Treasury Department "Sleeping With The Enemy?"* 6 KAN. J. L. & PUB. POL'Y 49, 50 (1996) (arguing that Service's original proposed regulations were "bad policy-making" and represented Treasury Department's pandering attitude towards charities); Wirtschafter, *supra* note 25 (concluding that IRS "compromised [its] organizational integrity" when it issued the proposed regulations). The more accurate view, however, is that charities (particularly the college football marketeers) enjoyed considerable influence in Congress and the Service recognized that charities would soon convince Congress to enact legislation overruling the Service's decision to tax sponsorship revenue. Nancy J. Knauer, *How Charitable Organizations Influence Federal Tax Policy: "Rent-Seeking" Charities or Virtuous Politicians?*, 1996 WIS. L. REV. 971, 1023-24. Having correctly recognized that it was about to lose the fight to preserve the goal of UBIT with regard to sponsorship revenues, the Service instead settled for second best by seeking to maintain some influence over the final product. James J. McGovern, *Service's McGovern Explains Proposed Corporate Sponsorship Regulations*, 58 TAX NOTES 795, 796 (1993).

³⁰ Prop. Treas. Reg. § 1.513-4, 65 Fed. Reg. 11,012 (2000).

to articulate a difference between sponsorship and advertisement. But like its earlier conclusion that there was no difference, the Service's forced assertion that indeed there is a difference is largely, and necessarily, intuitive. As a result, the revised regulations are subject to easy, though in this case quite principled, refutation largely for the reasons later stated in Part IV—i.e., the very scientific marketing communication process depends on subtle appeals to the consumer equally available from charitable and taxable media and, therefore, taxing one media and not the other will create a distorting market effect to the disadvantage of taxable media.

It really doesn't take high science, though, to know that exempting revenues derived from sponsorship undermines the purpose of the UBIT, at least with regard to the marketing of audience. Nevertheless, as discussed in Part IV, marketing communication science is thoroughly misunderstood or, more likely, ignored altogether in Congress' decision to exempt revenues derived from a charitable media's acknowledgement of a profit-seeker's payment.³¹ Sophisticated marketing communication has progressed beyond the stereotypical—that characterized by an explicit request to "buy now!" or an explicit assertion that a profit-seeker's product is better than all the rest and therefore should be preferred over any other brand.³² Part IV shows that marketing communication is a

³¹ A 1992 Congressional Research Service Report informed Congress that the charitable solicitation of sponsorship revenue competed with taxable media's solicitation of advertising revenue. See Zimmerman, *supra* note 18. Congress nevertheless decided to exempt such revenues from taxation in 1997. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 965, 111 Stat. 788, 893-94 (1997).

³² Internet Advertising Bureau and Millward Brown Interactive, 1997 INTERNET ONLINE ADVERTISING EFFECTIVENESS STUDY at 25 (available at <<http://www.iab.net>>) (visited Nov. 15, 2000).

While an immediate purchase response to advertising would be ideal, it is the rare exception. Rather than inducing consumers to "buy right now," most advertising works by locking appropriate brand-linked memories into long-term memory. By doing so, the advertising creates expectations for brands such that the consumer is more willing to try the product when in an experimentation mood (packaged goods) or is more likely to investigate the product further (in the case of considered purchase products).

much more subtle endeavor largely and sometimes solely dependent upon simple brand awareness equally obtained from sponsorship as from stereotypical advertising. Indeed, sponsorship is no longer viewed as a philanthropic or altruistic act unmotivated by the receipt of *quid pro quo*. It is, instead, an unabashedly profit-maximizing behavior with the same ultimate goal as stereotypical advertising.³³ To the extent, then, that charitable media is able to sell the same product—audience access for the purpose of generating profits—as taxable media without having to incur the tax cost of doing so, the market distortion sought to be eliminated by the UBIT—again assuming the validity of the concerns motivating UBIT—remains.

The futility of the Service's efforts will nowhere be more apparent than in Cyberspace. Part V will revisit the empirical data regarding the ways and means of marketing communication, giving particular attention to the burgeoning science of marketing products and services via the Internet. Already, the Service's attempt to distinguish sponsorship banners from advertising banners seems entirely over-simplistic and indeed outdated relative to the progress of information systems science. Tax-free sponsorship revenue is said to occur when a charity displays a profit-seeker's hyperlinked, but non-blinking banner in exchange for cash (assuming the message contained in the banner contains no inducements to buy), while taxable advertising revenue results from displaying a hyperlinked, blinking banner (even though the banner contains no inducements to buy).³⁴ Here again, the Service's conceptualization

Id.

³³ Richard Speed & Peter Thompson, *Determinants of Sports Sponsorship Response* 28 ACAD. MARKETING SCI. J., 226, 227 (2000).

Sponsorship has been defined as "provision of assistance either financial or in kind to an activity by a commercial organization for purposes of achieving commercial objectives. The involvement of a second party, that is, the activity sponsored, distinguishes sponsorship from advertising, and the commercial motivation distinguishes sponsorship from altruism."

Id.

³⁴ Chasin et al., *supra* note 9.

of advertisement under the Pavlovian stimuli-response model is apparent and, as profit-seekers surely know, very much behind the evolution of web-based marketing communications.

The emergence of the Web, of course, was not the impetus for the legal fiction that sponsorship is somehow different from advertisement. The Web acts instead to complicate the regulatory effort to defend and maintain the plausibility of that legal fiction.³⁵ In the real world, the separation between mere acknowledgement of a profit-seeker's economic support on the one hand, and a profit-seeker's explicit inducement to buy on the other allows for plausible deniability. That is, in the real world, the Code can plausibly assert that charitable media's marketing of audience share is different from, and therefore noncompetitive with, taxable media's marketing of audience share. The plausibility is made possible primarily by the enforcement of separate spatial and nonspatial positions for sponsorship and stereotypical advertisements so that there is always a distance between the two. Thus, a charity's display of a profit-seeker's logo and even its products, is mere acknowledgment when it is not accompanied in time or space by qualitative inducements. As a practical matter, the profit-seeker is forced to await some other time or place in which to present the viewer with a qualitative inducement to buy. In Cyberspace, though, distance is nonexistent, whether measured by reference to time or geography.³⁶ In other words, there is no "distance" between two positions in Cyberspace.³⁷

³⁵ In its notice of proposed rulemaking with regard to the revised proposed regulations, the Service solicits public comment regarding the application of the sponsorship/advertisement distinction in Cyberspace. See *Taxation of Tax-Exempt Organizations' Income from Corporate Sponsorship*, 65 Fed. Reg. 11,012, 11,015 (to be codified at 26 C.F.R. pt. 1 (proposed Mar. 1, 2000)).

³⁶ "In [Cyberspace], on which every computer screen is a window, actual, geographic distance is irrelevant." Simon, *supra* note 2, at 958.

³⁷ After only a little time "surfing" the web, even the most computer illiterate user will know this fact intuitively. Nevertheless, I include several user observations to confirm intuition. For example, "the power of the Web stems from the ability of a link to point to any document, regardless of its status or physical location." *American Civil Liberties Union v. Reno*, 929 F. Supp. 824, 837 (E.D. Pa. 1996).

A web viewer of what the Code defines as a mere acknowledgement is not some requisite distance away from an explicit inducement to buy such that charitable media's marketing of audience share has no effect on taxable media's revenues from marketing audience.³⁸ A web viewer is instead a viewer, according to the viewer's own volition, of any explicit inducements to buy associated (in the Cyberspace sense) with that acknowledgement. There is no motivation to create, much less enforce, spatial or nonspatial distances in Cyberspace (as Cyberspace is intended to exist).³⁹ Therefore, whatever plausibility supported the distinction between sponsorship and stereotypical advertisement in the real world is simply nonexistent in Cyberspace.

Part IV, the article's concluding section, articulates two possible solutions to the Service's dilemma. To maintain the plausibility that exempting sponsorship revenues from taxation does not result in market distortion, the Service must tax the revenues derived from any form of web-based acknowledgment that is hyperlinked⁴⁰ to a profit-seeker's web page containing information that would constitute advertising. Any other regulatory effort will be undoubtedly in vain, as the web

³⁸ In *American Civil Liberties Union v. Reno*, the court found that the links on the Web are designed to take a viewer from one document to another in one tenth of a second. *Reno*, 929 F. Supp. at 837.

³⁹ Indeed, it is axiomatic that the "World Wide Web was designed for linking." Ira S. Nathenson, *Internet Infoglut and Invisible Ink: Spamdexing Search Engines With Meta Tags*, 12 HARV. J.L. & TECH. 43, 88 (1998).

⁴⁰ See Clark, *supra* note 2, at 1334.

A hyperlink is text or some other screen element, such as an image, that when clicked on with a mouse pointer, opens another electronic document. The element to be clicked on is "linked" to the desired document with special programming and the electronic address of that document; this address can identify any document on any server computer that is connected to the Internet. Hyperlinked text (text that is to be clicked on, also known as *hypertext*) is usually colored differently than surrounding text, or underlined, or both. A mouse pointer moved over a hyperlinked element changes form, e.g., from an arrow to a hand with one finger extended, to indicate that clicking on this element will activate a hyperlink.

Id.

continues to condense and make entirely irrelevant the concept of distance. Recalling though, that the supposed dire consequences of not taxing charity when it markets its audience (or engages in any sort of unrelated business activity) are simply unlikely, the Service could decide to ignore the fundamental characteristic of Cyberspace—the condensation of time and space—and thereby acknowledge the fact that hyperlinking destroys the utility of spatial and nonspatial distance. Under this proposal, a web banner appearing on a charity's web site would be judged sponsorship or advertisement solely at face value and without regard to a hyperlinked page accessible via the banner, or the probability that the banner will induce the viewer to view the hyperlinked page. Both proposals are preferable to an attempt to perpetuate a distinction between sponsorship and advertisement in Cyberspace because the real world distinction is based upon the enforcement of distance between information and the concept of distance is irrelevant in Cyberspace.

II. THE LOGIC OF THE UBIT IN REALITY AND VIRTUAL REALITY

There is something surreal about the notion that if charities are allowed to systematically engage in noncharitable, profit-generating activities without being taxed, they will inevitably prevent all other taxable entities from engaging in the same activity.⁴¹ It is as though charitable entities repre-

⁴¹ The UBIT was added to the Tax Code by the Revenue Act of 1950. Pub. L. No. 81-814, § 301, 64 Stat. 906, 947-53 (1950) (codified as amended at I.R.C. §§ 502, 511-514 (1994)). Referring to the perceived need to impose the unrelated business tax scheme, the Senate Finance Committee stated that if certain transactions were not addressed "exempt . . . organizations may own the great bulk of commercial and industrial real estate in the country." S. Rep. No. 81-2375, at 31 (1950), *reprinted in* 1950 U.S.C.C.A.N. 3053, 3084 (referring to "sale-leaseback" transaction to which I.R.C. § 514 (1994) is addressed).

At the time that the [UBIT] was enacted, some argued that without the tax businesses owned by exempt nonprofits would exploit their cost advantage to drive their for-profit competitors out of business. In this way, it was said, whole industries might ultimately be captured by nonprofits.

sent a kind of initially benevolent creation that, if left unattended, might easily mutate into a malevolent entity. Because of their tax exemption, the reasoning goes, charities will be able to undercut prices, on the one hand, and expand faster than taxable participants on the other.⁴² Eventually, economic activity will be monopolized by nonprofit entities. The UBIT, which makes charities pay the same tax as taxable entities when those charities are engaged in noncharitable activities, is designed to prevent that consequence.

The surrealism in the feared consequences derives, perhaps, from the fact that entities are merely individuals who join together to engage in economic activities, and from the unlikely Utopian idea that most individuals really would prefer altruism over personal wealth if only the tax laws would not tax their joint efforts. That is, individuals would prefer to produce and market commodities at cost for the common good, rather than for personal profit. After all, the price of conducting business in the nonprofit form—the price that individuals and their society would bear in allowing the nonprofit form to dominate economic activity—is the accumulation of personal wealth.⁴³ Individuals who engage in activities under the nonprofit form must adhere to the “nondistribution constraint”⁴⁴ and therefore cannot take unto themselves any profit generated by the activity. To say that unchecked, unrelated business

Henry B. Hansmann, *Unfair Competition and The Unrelated Business Income Tax*, 75 VA. L. REV. 605, 609 (1989).

⁴² Note, *Colleges, Charities, and The Revenue Act of 1950*, 60 YALE L.J. 851, 875 (1951). For an oft-cited critique of these arguments from an economic standpoint, see Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982).

⁴³ The prohibition against private inurement, contained in I.R.C. § 501(c)(3) (1994 & Supp. IV 1998), prohibits a charity's distribution of profit. I.R.C. § 4958 (Supp. IV 1998) imposes personal liability on the recipients of such profit, as well as on “organization managers” who knowingly allow such distribution. For a detailed discussion of the prohibition against the distribution of profit, see Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575 (2000).

⁴⁴ Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838-839 (1980) (using phrase, “nondistribution constraint” to describe prohibition against profit distribution characteristic of nonprofit organizations).

of charities would drive out taxable activity is therefore to accept the surrealist notion that most people do not want to get rich.

The preceding point is most valid from a macro-economic standpoint. That is, whole industries are likely to be dominated by charities only to the extent most individuals want to forego the chance for individual wealth inherent in the conduct of the industry. Only to the extent that individuals can conduct the activity and still get rich will the premise of charitable hegemony with regard to a particular industry hold true.⁴⁵ In the micro-economic sense, the premise of UBIT has somewhat greater, though still questionable, validity. Suppose, for example, an economy with just two firms, one taxable and the other nontaxable. If all other things are exactly identical, it should be expected that the nontaxable entity could produce a commodity at less cost than its taxable counterpart, charge lower prices, and thereby reduce or eliminate the taxable participant's profits.⁴⁶ But to do so, the nontaxable entity

⁴⁵ This assertion is implicit in the previously articulated observation that if an activity holds the potential for profit, investors will contribute capital to the conduct of that activity. See Comment, *Preventing the Operation of Untaxed Business By Tax-Exempt Organizations*, 32 CHI. L. REV. 581, 592 (1965).

⁴⁶ The assertion that an income tax is not a cost of production and therefore will not have an impact on the costs of commodities sold by nonprofit organizations has been adequately addressed elsewhere:

The income tax, being a levy on profits, is not, it is argued an element in the cost of production and hence will not affect the price at which the sellers of commodities are willing to offer their wares to the public. Contrary views have been expressed by eminent authorities who hold that while it is true that the income tax is not an element in the cost of production, nevertheless, a manufacturer who knows that he will not have to pay any income tax can afford to fix his prices at a point where the profit would be smaller than that of his competitor who must pay the income tax. People do not engage in business, it is argued, to gain less than a certain minimum profit or risk their capital to the hazards of trade for insubstantial returns. Profit itself, we are told, enters into the determination to undertake enterprises and is an element in the determination of prices; and if such be the case, it is obvious that a tax levy on profits would be an important element in the consideration of the price structure, and the exemption from the income tax would be a substantial benefit to a competitor.

would have to reduce or eliminate its own profit margin as well. That is, the nontaxable entity would be required to reduce prices below its competitor's, and eventually its own cost, and thereby share some of its tax exemption with consumers.⁴⁷ This sort of predatory pricing is unlikely,⁴⁸ assuming, as the UBIT regime does, that the nontaxable entity's participation in the particular industry is motivated by profit maximization.⁴⁹ First, a charity would have to accept great and prolonged risks to its own economic well-being, depending on how long the price war continues and the charity's own financial stability, and would probably not recoup the costs incurred in doing so.⁵⁰ Second, a nontaxable entity, is by defini-

Maurice Finkelstein, *Freedom From Uncertainty In Income Tax Exemptions*, 48 MICH. L. REV. 449, 460 (1950).

⁴⁷ Consider the following discussion from an early writer on the subject:

[T]he price-cutting advantages of an exempt over a taxable business are dubious. Suppose two corporations are identical in all respects except that A is tax-exempt and B is not. Assuming the corporate tax rate to be 50%, if A is making 10 [cents] on the dollar, then B is making 5 [cents]. If A cuts its price so that it makes only 5 [cents], B will cut its price until it is making only 2 1/2 [cents]. This price cut has resulted in a greater absolute loss to A than to B. If A further cuts its prices until it makes only 1 [cent], B will cut its prices until it is making 1/2 [cent]. It is apparent that A's absolute advantage over B declines proportionately as prices are cut lower and lower. Of course, it may be possible for A to maintain its price-cutting policy until B goes out of business, and then raise prices again. But it will be a severe drain on A's financial resources so long as the price war continues. And it seems unlikely that exempt institutions like universities and hospitals, which are clamoring for funds, will forego current income on the risk that they can drive out a competitor after a lengthy price war.

Note, *Colleges, Charities, and The Revenue Act of 1950*, 60 YALE L.J. 851, 876 (1951).

⁴⁸ Indeed, market theorists are still debating whether predatory pricing—lowering prices in an effort to drive competitors from the market with the ultimate goal of gaining the monopolistic power to set prices even higher than they were before the price cutting war began—has ever been employed even by taxable competitors. Thomas W. Hazlett, *Microsoft's Internet Exploration: Predatory or Competitive*, 9 CORNELL J.L. PUB. POL'Y 29, 33 (1999).

⁴⁹ Rose-Ackerman, *supra* note 17 at 1024 ("Nonprofit firms engage in tax-exempt business activity to provide funds to subsidize their primary activities. Therefore they want to maximize expected profits.").

⁵⁰ The cost of predatory pricing is the profit lost during the period of time it

tion precluded from being "exactly identical" to a taxable participant. The inability to distribute profit to its stewards will prevent the nontaxable entity from being as efficient as a taxable entity.⁵¹ To make up for its lower efficiency (i.e., to compensate the consumer for lower quality or quantity),⁵² the nontaxable entity would be required to reduce prices to an even greater extent than it would if it were as efficient as its taxable competitor. As an alternative, the nontaxable participant could increase agency costs while offering reduced prices.⁵³ The financial value of tax exemption, otherwise available to subsidize the nontaxable entity's predatory behavior,

takes to force a competitor from the market. See *supra* note 47 and accompanying text. To recoup that cost, the predatory actor would need to raise prices after its other competitors have left the market and incur costs to prevent other competitors from reentering the market (without barriers, reentry is possible once the predatory actor raises prices again). See Hazlett, *supra* note 48, at 32. Having prevailed in the initial price war at significant cost, a charitable entity is unlikely to have sufficient resources left to defend its monopoly through the erection of further market barriers.

⁵¹ Some economists, in arguing that the absence of UBIT might allow charities to engage in price-cutting, inexplicably assume away a charity's lower efficiency level. Their analysis assumes instead that nonprofits and for-profits are equally efficient. See, e.g., James R. Hines, Jr., *Non-Profit Business and The Unrelated Business Income Tax*, in 13 TAX POLICY AND THE ECONOMY 57, 63-64 (assuming that nonprofits are not disadvantaged by their form); Rose-Ackerman, *supra* note 17, at 1030 (assuming that nonprofits are no less efficient than for-profits).

⁵² "Charitable organizations are plagued by incentive problems. Nobody owns the right to the profits and therefore no one has the spur to efficient performance that the lure of profits creates." *United Cancer Council, Inc. v. Commissioner of Internal Revenue*, 165 F.3d 1173, 1179 (7th Cir. 1999). "Of course, one would expect that when the profit motive is eliminated a price is paid in terms of incentives. For example, nonprofit firms might be expected to be slower in meeting increased demand and to be less efficient in their use of inputs than for-profit firms." Hansmann, *supra* note 44, at 844.

⁵³ Agency costs are incurred to eliminate waste and spoilage that result when (as is always the case) an agent's interests are not perfectly aligned with those of her principle. See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1995). Thus, for example, in an employer/employee relationship, an employer may incur certain costs (e.g., hiring more supervisors to enforce higher level job performance, or instituting a bonus compensation plan) to eliminate the naturally occurring divergence between the interests of principle and agent. Because of the lack of profit motives, charitable organizations are likely to have higher agency costs.

would be consumed by the higher costs or lower prices. At best, the nontaxable entity would only break even, and its profit-maximization goal would fail. The nontaxable entity would simply be participating in an unprofitable endeavor. If, instead, the nontaxable entity could participate in profit-seeking endeavors without risking its own existence (as it would in a price war) or sacrificing its tax exemption to lower prices or higher efficiency costs, we should expect that it would do so. Thus, the nontaxable entity could garner more profit by not undercutting prices (i.e., maintaining prices at the level charged by taxable participants) in the particular industry⁵⁴ but instead devoting some of the tax windfall to its higher efficiency costs so that it comes close to being "exactly identical" to its taxable competitor. The nontaxable entity would then earn only the same after tax yield as the taxable competitor. As a result, the nontaxable firm will share in the market profit, rather than monopolize the industry or participate in an unprofitable endeavor.⁵⁵ In the alternative, the nontaxable

⁵⁴ "In fact, if tax-exempt firms have no special efficiency advantages in any industry, one would expect them to seek to maximize returns by establishing firms in a broad range of industries, thus earning close to a competitive return in each one. Rose-Ackerman, *supra* note 17, at 1029.

⁵⁵ Hansmann, *supra* note 41, at 610-11.

[A] nonprofit firm that owns an unrelated business has an incentive to expand that business slowly if at all. In this manner, the nonprofit leaves undisturbed the price that prevails when only for-profit firms compete, and thereby maximizes the difference between cost and sales price. Nonprofits with substantial funds to invest—more than can be accommodated with ease in a single market or industry without entering on a scale, or expanding at a rate, sufficient to drive down prices—would have an incentive to spread those funds across a number of markets or industries and invest on a small scale in each industry to avoid disturbing existing price levels. Similarly, if a firm owned and operated as an investment a nonprofit that generated large earnings—earnings large enough so that, if reinvested in the firm, they would lead to a substantial increase in output and a consequent lowering of industry price levels—the nonprofit would have an incentive to withdraw a large portion of those earnings from the firm and invest them elsewhere. Such a strategy would assure the maximum rate of return on investments in unrelated businesses. At the price level needed to cover costs for a for-profit firm paying taxes, a tax-exempt firm could potentially earn pure profits at least equal to the amount of taxes that would

entity might simply invest in one or more taxable participants in various markets and thereby obtain a portion of the profit garnered by those taxable participants.⁵⁶ From even a micro-economic sense, the consequences motivating the UBIT are unlikely.

The validity of the concerns motivating UBIT are further challenged by the emergence and continued growth of Cyberspace. First, the ratio of cost to profit in Cyberspace is so low, as compared to the ratio in the real world,⁵⁷ that the potential for individual wealth accumulation overwhelms any motivation individuals might have to enter Cyberspace using the nonprofit form. Indeed, judging by the continued infusion of investor capital, Cyberspace is benefiting from the perception, if not reality, of huge profit potential.⁵⁸ For the nonprof-

otherwise be assessed. Rapid increases in capacity through internal expansion would often reduce the price level and, hence, the rate of profit.

Id.

⁵⁶ Charities are exempt from taxation on dividends. See I.R.C. § 512(b)(1) (1994 & Supp. IV 1998). But investing in the stock of taxable corporations would not result in greater returns than engaging in the corporation's business directly since the corporation will pay tax on earnings before distributing those earnings to the charitable shareholder. See I.R.C. § 11 (1994).

⁵⁷ The United States Commerce Department provides the following anecdote:

The *New York Times* invested \$350 million in its new printing press Web content businesses requiring a much lower capital investment than their print counterparts, lower the barrier to entry in this online industry. With the Internet, the content of a newspaper or a magazine does not have to be printed and delivered to news stands or doorsteps across the city in order to be consumed—steps that add 30 to 40 percent to the cost of the product. Instead, content delivered via the Internet can be entered directly into a computer, stored digitally on a server and appear directly on a reader's computer screen with a few simple commands the reader enters on the Web site The publisher's distribution costs include paying off the investment in the Web servers and other technology Once the content has been created and stored, there is little or no extra cost to send it to one reader or 1,000 readers.

Lynn Margherio, Dave Henry, Sandra Cooke, Sabrina Montes & Kent Hughes, *The Emerging Digital Economy*, at 25 (1988) available at <<http://www.ecommerce.gov/ecomnews/emerging.htm>> (visited Sept. 2, 2000).

⁵⁸ In just the first quarter of 2000, venture capitalists invested \$22.7 billion in companies, the largest single portion of which (\$17.05 billion) was in Internet-related companies. *Venture Capital Investments Increase 266% to 22.7 Billion in*

it form to rise to dominance in Cyberspace, even with the advantage of tax exemption (that is, even in the absence of the UBIT), individuals who conduct economic activity in Cyberspace would have to forego that profit potential. The likelihood of that happening in a capitalist world is perhaps lower than words can express. The infusion of investor capital, too, eliminates the feared consequence that without UBIT charities can expand at a faster rate than taxable entities since the nondistribution constraint effectively prevents charities from participating in the free-flowing capital markets. So long as investors are clamoring to invest in and profit from Cyberspace activity, charities are more likely to suffer a disadvantage, rather than an advantage, from tax exemption because the value and benefit of capital markets to taxable entities most likely far exceeds the value and benefit provided by tax exemption to charities.

There is perhaps an even more fundamental reason why UBIT is unnecessary, at best, in Cyberspace. The premise of charitable hegemony that motivates UBIT is largely related to the 20th century industrial marketplace model, potentially controlled by malevolent participants who are able to own and manipulate fixed tangible assets. Cyberspace, though, epitomizes a 21st century informational marketplace and it remains a very open question whether an informational marketplace is subject to the sort of monopolization thought prevented by UBIT.⁵⁹ The premier asset of Cyberspace is intelli-

Q1 2000: *Internet-Related Companies Capture the Most Investments*, <http://www.nvca.org/Vepress05_04_00.htm> (visited Nov. 17, 2000).

⁵⁹ On the subject of new market place and relative power therein, the Commerce Department states:

The potential of e-commerce technologies to transform business practices is evident in the new marketplaces that are developing online. These important intermediaries have emerged rapidly in virtually all industries, providing new places for buyers and sellers to meet, allowing a variety of pricing schemes to flourish, altering the roles of traditional intermediaries, enabling complex transactions, and, by making vast amounts of information available at very low costs, shifting the balance of power among market participants.

United States Department of Commerce, *Digital Economy 2000*, at 16 (2000)

gence—an unfixed, intangible asset. Already, the Supreme Court has likened Cyberspace to a public place where content is entitled to the highest form of First Amendment protection.⁶⁰ It hardly seems possible, then, that the informational assets of Cyberspace can be harnessed and monopolized by any single entity, regardless of that entity's relative ability to accumulate capital, and then used exclusively to that entity's financial benefit.⁶¹

For the moment, though, the Code continues to accept as true and likely the fears that motivated the enactment of the UBIT. The sale of advertising space—"marketing audience"—is one of two activities to which the Service has recently devoted particular attention with regard to UBIT.⁶² Moreover, the Service is currently addressing the application of UBIT in Cyberspace.⁶³ The next two sections implicitly accept

<<http://www.esa.doc.gov/de2000.pdf>> (visited Nov. 2, 2000).

⁶⁰ *Reno v. American Civil Liberties Union*, 521 U.S. 844 (1997).

⁶¹ "No single organization controls any membership in the Web, nor is there any single centralized point from which individual Web sites or services can be blocked from the Web." *Id.* at 853 (quoting *American Civil Liberties Union v. Reno*, 929 F. Supp. 824, 838 (1996)). Earlier, the lower court found that:

Such diversity of content on the Internet is possible because the Internet provides an easy and inexpensive way for a speaker to reach a large audience, potentially millions. The start-up and operating costs entailed by communication on the Internet are significantly lower than those associated with use of other forms of mass communication, such as television, radio, newspapers, and magazines. This enables operation of their own Web sites not only by large companies such as Microsoft and Time Warner but also by small not for profit groups.

Reno, 929 F. Supp. at 843.

⁶² The other activity to which the Service has devoted attention vis-a-vis the UBIT is the conduct of tours and travel programs by exempt organizations. *See* Treas. Reg. § 1.513-7 (2000).

⁶³ Twice last year the Service indicated that it was considering the application of UBIT to charitable activities conducted in Cyberspace and has called for public comment on the issue. 2000-42 I.R.B. 385 (Oct. 16, 2000); Taxation of Tax-Exempt Organizations' Income from Corporate Sponsorships, 65 Fed. Reg. 11,012, 11,015 (2000) (to be codified at 26 C.F.R. pt. 1) (proposed Mar. 1, 2000). In its first call for public input, the Service asked:

The IRS and the Treasury Department are reviewing the application of existing tax laws governing exempt organizations, including the UBIT rules, to Internet activities. Comments are specifically requested on . . .

the notion that a charity's tax-free conduct of an unrelated trade or business is harmful to taxable entities and the market economy, but only for the sake of comparing the distinction between sponsorship and advertising revenues, and how and whether that distinction should apply in Cyberspace.

III. THE TAXATION OF ADVERTISING AND SPONSORSHIP

The foregoing economic logic has never given pause to Congress or the Service's efforts to "protect" taxable entities from unfair competition. Those efforts have continued unimpeded⁶⁴ and have produced one of the definitional peculiarities with regard to the UBIT scheme. In the technical language of the Code, UBIT applies when a charity regularly engages in an unrelated "trade or business."⁶⁵ In the late sixties, the Service began considering whether the sale of advertising space constitutes a trade or business.⁶⁶ The Service concluded, and Congress subsequently agreed, that the marketing of audience is always a trade or business even though the space sold is within the context of some other media and, indeed, without regard to editorial content or purpose of that other media.⁶⁷ Thus, an educational institution that publishes a journal solely to educate its beneficiaries and a company that publishes a gossip magazine designed to entertain and attract more readers are equally engaged in a trade or business when they sell advertising space to profit-seekers. The sale of the space is analyzed separately from the context in

whether providing a link to a sponsor's Internet site is advertising within the meaning of section 513(i).

Id.

⁶⁴ See, e.g., Treas. Reg. § 1.513-7 (2000) (applying UBIT to travel tours conducted by nonprofit organizations).

⁶⁵ I.R.C. § 512(a) (1994 & Supp. IV 1998).

⁶⁶ For an historical overview of the Service's consideration of the UBIT treatment of advertising revenues see William J. Lehrfeld, *The Unfairness Doctrine: Commercial Advertising Profits as Unrelated Business Income*, 23 TAX LAW. 349, 351-352 (1970).

⁶⁷ The conclusion was embodied in regulations proposed and issued in final form in 1967. See Notice of Proposed Rulemaking, 32 Fed. Reg. 5,993 (April 14, 1967); Notice of Final Rulemaking, 32 Fed. Reg. 17,657 (1967).

which the space occurs and is thereby irrefutably considered a trade or business.⁶⁸ And, according to the Service and Congress, if the advertising is unrelated to the educational institution's charitable mission, it has the potential to compete unfairly with the gossip magazine.⁶⁹

Certainly, the creation of advertising substance—i.e., marketing of persuasive speech—is normally thought of as a trade or business without regard to the context in which the speech occurs. If a charity engaged in the editorial process of creating advertising copy, the conclusion that it was indeed engaged in a trade or business would not challenge normal understanding. But the marketing of audience, as opposed to marketing of persuasive speech, is largely dependent upon the

⁶⁸ "In the statement of a type of per se rule, the soliciting, selling, and publishing of commercial ("consumer") advertising is an unrelated trade or business even though the advertising is published in a periodical which contains editorial matter related to the exempt purpose of the organization." *Id.* Lehrfeld, *supra* note 66, at 355. The quoted statement is accurate only with regard to the determination that the sale of advertising is always a trade or business. The Supreme Court later held that though the sale of advertising space is always a trade or business by virtue of the regulations, it is not always unrelated and therefore does not invariably lead to taxable income. *United States v. American College of Physicians*, 475 U.S. 834 (1986).

⁶⁹ The UBIT regulations require only that an activity have the potential to compete with taxable activities. See Treas. Reg. 1.513-1(b) (2000) (referring to activities which "present the sufficient likelihood of unfair competition" and thus are within the policy of unrelated business income tax). It is also difficult to conceive of advertising that is "related" to a charitable function, given the Supreme Court's imposition of a rather high bar in *United States v. American College of Physicians*, 475 U.S. 834 (1986). In that case, the Court found the advertising described in the following excerpt to be unrelated:

The Annals of Internal Medicine (Annals) [is] a highly regarded monthly medical journal containing scholarly articles relevant to the practice of internal medicine. Each issues of Annals contains advertisements for pharmaceuticals, medical supplies, and equipment useful in the practice of internal medicine, as well as notices of positions available in that field. Respondent has a longstanding policy of accepting only advertisements containing information about the use of medical products, and screens proffered advertisements for accuracy and relevance to internal medicine.

Id. at 836. In an early informal setting, the Service opined that advertising dealing with probate notices, service of process, and appointments of receivers appearing in a daily law reporter would be related. Lehrfeld, *supra* note 66, at 356 n.26.

creation of news, sports, information, and entertainment (i.e., "media") by persons having the specific intent to attract marketers of persuasive speech.⁷⁰ The media, by which audience is obtained and then marketed, is not created primarily to benefit an already existing audience. In the business of marketing audience, media is created specifically to generate, maintain, and increase audience and thereby better attract marketers of persuasive speech. Competition is manifested in the search for new and even more creative means of generating audience. The key and rather obvious difference with regard to charities is that the purpose of charitable media is speaking to or benefiting an already existing audience – one composed of charitable beneficiaries whose interests are, at least with regard to any particular charity, assumed to be static and unchanging. The content of that media is therefore unchanging and not at all responsive to evolving tastes, fads, and styles in a constant effort to generate, maintain, and increase audience. Indeed, charitable media assumes that the audience's interests are entirely unchanging. To conclude, first, that the marketing of audience is always a trade or business makes no sense, particularly since charitable media is relatively devoid of profit potential.⁷¹ To further assert that

⁷⁰ The marketing of audience is, to a much lesser but still significant degree, also dependent upon the ownership of space. Thus, an owner of a billboard along a highly traveled thoroughfare will have better success selling advertising space than an owner of a billboard along a little traveled thoroughfare.

⁷¹ There are, of course, glaring exceptions such as NCAA sporting events. The statutory consideration of the term "trade or business" as it relates to advertising relies upon objective indications that an entity is actually seeking profit. Those objective indications are necessary to find that an activity is a trade or business. For example, I.R.C. § 513(c) states, "where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit." I.R.C. § 513(c). The regulations, though, suggest that an entity need only be seeking "income" for an activity to be considered a trade or business: "Accordingly, for purposes of section 513 the term 'trade or business' has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services." Treas. Reg. § 1.183-2(b)(1)-(9) (2000). But in yet another twist, the definition of "trade or business" as used in I.R.C. § 162 (which definition is adopted for purposes of the UBIT) is further elaborated on in Treasury Regulation 1.183-2. That regulation lists nine

the static and unresponsive media—unresponsive to tastes and styles, that is⁷²—produced by charities is potentially “competitive” is obviously even more nonsensical since such media can hardly garner the audience necessary to siphon advertising revenues from taxable media.

At first, some in the Treasury Department resisted the notion that the marketing of audience could be viewed as a “trade or business” regardless of the nature of the media providing access to that marketed audience.⁷³ They adhered, essentially, to the more global notion, discussed above, that the sale of advertising space was essentially the marketing of the media that generated and attracted audience. If the media itself was related to the charitable goal, then any advertising contained therein did not give rise to unrelated business income.⁷⁴ That position was obviously, though not explicitly, based more on the lack of competitive impact on taxable media, than on the notion that advertisement appearing in charitable media was *ipso facto* related to a charitable purpose. An advertisement for an analgesic, for example, is generally unrelated to the educational goals of a law review in which it may be found, but neither is it likely to have an impact on the sale of advertising space by publishers of TV Guide. This rather obvious logic failed though, and opponents within and outside of the Treasury Department were finally silenced when the Supreme Court labeled the taxation of advertisement regard-

factors by which to distinguish a trade or business (expenses of which are fully deductible) from a “hobby” (expenses of which are deductible only to the extent of income derived from such activity). *Id.* Every one of the nine factors focuses on objective facts that indicate a search for profit, not just income. Indeed, the discussion of each factor uses the term “profit.” *Id.*

⁷² One need only compare any law review article appearing in this publication with any law review article appearing in a ten year old issue of this publication to see that the writing style (admittedly relatively dry and certainly academic) has intentionally and perhaps necessarily remained constant over the years.

⁷³ Lehrfeld, *supra* note 66, at 351-352 (discussing conflict between Internal Revenue Service’s Tax Ruling Division, whose approach would tax revenues from sale of advertising revenue without regard to editorial content, and Service’s Office of Chief Counsel, which opposed that approach).

⁷⁴ *Id.*

less of media context "revolutionary,"⁷⁵ but nevertheless upheld it as a valid exercise of executive and legislative prerogative.⁷⁶

Neither the Treasury regulations nor I.R.C. § 513(c) precisely defined the term, "advertisement," suggesting that its meaning was self-evident. In its 1991 "Cotton Bowl" ruling, the Service in effect applied an intuitive definition, ruling that the Cotton Bowl Athletic Association (CBAA) earned unrelated business income when it entered into a "sponsorship" agreement with the Mobil Oil Corporation (Mobil).⁷⁷ In essence, the arrangement required CBAA to prominently display Mobil's logo in all of CBAA's promotional material, as well as on and around the football field where CBAA's football game was to be played and indeed on every player's jersey.⁷⁸ The CBAA also agreed to provide space for Mobil's more stereotypical advertisements.⁷⁹ The Service's subsequent determina-

⁷⁵ *United States v. American College of Physicians*, 475 U.S. 834, 839 (1986),

⁷⁶ *Id.* at 850. Chief Justice Berger opined that exempting from taxation revenues derived from advertising appearing in publications related solely to the publisher's exempt purpose would be appropriate, but that the Service's contrary approach was "permissible." *Id.* at 850 (Burger, J. concurring).

⁷⁷ Tech. Adv. Mem. 91-47-007 (Aug. 16, 1991).

⁷⁸ *Id.* The ruling released by the Service was edited almost to the point of being nonsensical, but the relevant facts were subsequently reported in trade journals. See Paul Streckfus, *A Glimpse of Mobil-Cotton Bowl Contract Provisions*, 55 TAX NOTES 447 (1992) (reporting particular provisions of contract between CBAA and Mobil Oil); Amy Forsythe, *Implications of The Cotton Bowl Ruling on The Exempt Status of Intercollegiate Athletic Organizations* 6 EXEMPT ORG. TAX REV. 933, 933 (1992) (reporting that Mobil Oil paid CBAA \$1.5 million under contract).

⁷⁹ Streckfus, *supra* note 78 at 447.

For anyone not familiar with the Mobil Cotton Bowl, here is what you see and hear when you turn on your television set New Year's Day. First, you are told you will be watching the "Mobil Cotton Bowl Classic." Then, as the announcers talk about the teams, you are shown the football field, with the name of the game—Mobil Cotton Bowl Classic—emblazoned on the 50-yard line, the Mobil logo at each 30-yard line, and the name "Mobil Cotton Bowl" filling each end zone. Each player has a patch on his uniform saying "Mobil Cotton Bowl Classic." Each time the game score is flashed on the screen it is accompanied by the heading, Mobil Cotton Bowl. In case there is anyone who doesn't know who or what Mobil is, regular ads, presumably purchased from NBC, extol the

tion that the payment made to CBAA was entirely for advertising and thus taxable as unrelated business income revolved around the idea that CBAA was providing a "substantial return benefit."⁸⁰ From this, the Service concluded that CBAA's receipt of payment implicated the unfair competition rationale of the UBIT. The Achilles heel, though, of the Service's approach was its failure to articulate a reasoned definition of the term "advertisement."

Indeed, such an articulation was incumbent on the Service once it decided to ignore the formalistic label the parties applied to the arrangement (i.e., "sponsorship")⁸¹ and to apply UBIT principles according to the perceived economic substance—a substance the Service rightly determined to be marketing communication designed to increase sales. Articulating a substantive definition would have necessarily defended the notion implicit in the Service's findings that the accommodations derived from Mobil's payment to CBAA, although labeled "sponsorship," would have otherwise been obtained from taxable media.

A subsequent consequence of the Service's failure to articulate the meaning of "advertisement" was that its substantively correct determination equating sponsorship with advertise-

virtues of Mobil products during each advertising break.

Paul Streckfus, *IRS' Pre-Inaugural Gift For Charities*, 58 TAX NOTES 384, 384 (1993).

⁸⁰ Tech. Adv. Mem. 91-47-007 (Aug. 16, 1991). Five months later, the Service provided a more elaborate statement of its analysis:

Payments an exempt organization receives from donors are nontaxable contributions if there is no expectation that the organization will provide a substantial return benefit. Mere acknowledgement or recognition of a corporate contributor as a benefactor normally is incidental to the receipt of a contribution and is not of sufficient benefit to give rise to unrelated trade or business income. However, where an exempt organization performs valuable advertising, marketing, and similar services, on a *quid pro quo* basis, for the corporate sponsor, payments made to an exempt organization are not contributions to the exempt organization, and questions of unrelated trade or business arise.

I.R.S. Announcement 92-15, 1992-5 I.R.B. 51 (Feb. 2, 1992) (emphasis added).

⁸¹ For a discussion of early conceptualizations of "sponsorship," see *supra* note 10 and accompanying text.

ment (and taxing both) became subject to the regulatory equivalent of political "spin." Exempt organizations weighed in with numerous objections which, though valid on some secondary levels, were nevertheless unrelated to the primary question of whether that which Mobil obtained via its payment to CBAA could and would have otherwise been obtained from taxable media.⁸² The ultimate consequence was that the Service left itself without objectively neutral support for what was an empirically correct, though only intuitively expressed, conclusion. The unopposed universal condemnation, though largely unprincipled and indeed unresponsive to the substantive issue, left the entire issue to be decided on the basis of political expediency rather than principled tax theory (however debatable that theory may have been).

Once the issue moved from the realm of principled tax policy to simple politics,⁸³ the promulgation of the original

⁸² The Cotton Bowl Athletic Association, whose views were said to be representative of the nearly 300 comments submitted to the Service in opposition to its early position, accused the Service of engaging in a "lark and a frolic, writing tax law, not interpreting technical provisions." Streckfus, *supra* note 79, at 385. CBAA went on to implicitly admit the correctness of the Service's finding that CBAA was marketing a product not simply accepting a nontaxable donation. "[T]he IRS needs to face the reality today, that if corporations make substantial donations to tax-exempt organizations, they want something other than a pat-on-the-back in return." Cynthia G. Farbman, *Forced To Be A Fan: An Analysis and History of the IRS's Proposed Regulations Regarding Corporate Sponsorship*, 2 SPORTS LAW. J. 53, 61 (1995).

⁸³ One anecdotal legend of the entire process holds that a prominent attorney was overheard to brag, "as long as there were three Texans (the state where the Cotton Bowl is played) on the House Ways and Means Committee, the Cotton Bowl would never be taxed." Streckfus, *supra* note 79, at 385. In a more empirical vein, one commentator documents the growth and political influence of the charitable community:

[T]he [charitable] community demands "durable" tax subsidies as it jealously guards its present tax subsidies and urges the legislature to resist the application of doctrinally sound tax policy that might lessen the value of such subsidies. Finally, the rhetorical force of the new institutional role of the charitable community insures that any debate concerning the tax treatment of charitable organizations is cast in broad generalities and does not delve into the merits of the continued subsidy. This means that legislators need not evaluate each piece of pro-charity legislation. It is sufficient that the legislation is labeled "good for chari-

proposed regulations and the subsequent enactment of I.R.C. § 513(i) became a *fait accompli*, particularly in light of the taxable media's uncharacteristic abstention from the debate.⁸⁴ I.R.C. § 513(i) effectively defined advertisement in a manner excluding from taxation a certain form of marketing communication that would otherwise be purchased from taxable media. Revenues from "qualified sponsorship," defined as the unlimited display of a profit-seeker's brand name or logo, and even the unlimited display or distribution of the profit-seeker's products, were made nontaxable.⁸⁵ Revenues from advertisements, generally defined as qualitative messages regarding the profit-seeker or its products, or inducements to buy, were explicitly distinguished from sponsorship revenues and thus made presumptively taxable.⁸⁶ The Service dutifully followed the enactment of I.R.C. § 513(i) by issuing revised proposed regulations that, quite appropriately, simply adopt the distinction mandated by Congress insofar as sponsorship and advertising are concerned.⁸⁷

ty."

Nancy J. Knauer, *How Charitable Organizations Influence Federal Tax Policy: "Rent-Seeking" Charities or Virtuous Politicians?* 1996 WIS. L. REV. 971, 977.

⁸⁴ The small business sector, represented by various trade organizations and indeed the United States Small Business Administration (SBA) is the primary watchdog and whistleblower with regard to noncharitable business activities conducted by exempt organizations. See, e.g., Testimony of Russell Orban, Assistant Chief Counsel for Tax Policy Office of Advocacy U.S. Small Business Administration Before Internal Revenue Service Panel on Unrelated Business Income Tax February 10, 1999, at <<http://www.sba.gov/advo/laws/comments/ubit.html>> (visited Nov. 17, 2000); Unrelated Business Income Tax: Hearings Before the Subcommittee on Oversight of The House Committee on Ways and Means, 100th Cong., 1st Sess. (1987). Henry Hansmann, *Unfair Competition and The Unrelated Business Income Tax*, 75 VA. L. REV. 605, 605 (1989) ("There has recently been considerable agitation from the business community, and particularly from small businesses, against unfair competition from nonprofit firms."). *Id.* Inexplicably, though, the small business community did not take an active role with regard to the Service's efforts to tax revenues from sponsorship and advertisements.

⁸⁵ I.R.C. § 513(i)(1), *supra* note 28.

⁸⁶ *Id.*

⁸⁷ Notice of Proposed Rulemaking, 65 Fed. Reg. 11,012 (March 1, 2000). Nontaxable sponsorship includes the display of:

logos and slogans that do not contain qualitative or comparative descrip-

IV. THE SCIENCE OF MARKETING COMMUNICATION AND THE REQUIREMENT OF TIME AND PLACE

The anomaly in the law—that sponsorship revenues are not taxed though we may intuitively conclude that profit-seekers would otherwise pay taxable media for marketing communication space—results from an apparently intentional decision to ignore the science of marketing communication.⁸⁸ Ultimately, marketing communication focuses on the goal of generating and maintaining repeat consumer purchasing – a result referred to in the marketing industry as “brand loyalty.”⁸⁹ The exact language by which that goal is achieved is rather a secondary concern. Hence, sponsorship is viewed as a form of marketing communication, though it seeks brand loyalty without the explicit inducements characteristic of stereotypical advertisement.⁹⁰ Though both methods are intended

tions of the payor's products, services, facilities or company; a list of the payor's locations, telephone numbers, or Internet address; value-neutral descriptions, including displays or visual depictions, of the payor's product-line or services; and the payor's brand or trade names and product or service listings. Logos or slogans that are an established part of a payor's identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution, whether for free or remuneration, of a payor's product by the payor or the exempt organization to the general public at the sponsored activity is not considered an inducement to purchase, sell or use the payor's product for purposes of this section and, thus, will not affect the determination of whether a payment is a qualified sponsorship payment.

Id. Although I.R.C. § 513(i)(2)(A) excludes any mention of “slogans” as qualified sponsorship, the Conference Committee states, “as further clarification, the conferees intend that, as provided under Prop. Treas. Reg. 1.513-4 [i.e., the original proposed regulations], the use of promotional logos or slogans that are an established part of the sponsor's identity would not, by itself, constitute advertising.” H.R. CONF. REP. NO. 105-220, 105th Cong., 1st Sess. at 476, *reprinted in* 1997 U.S.C.C.A.N. 1129, 1288.

⁸⁸ See Zimmerman, *supra* note 18. A Congressional Research Service report was issued prior to the enactment of I.R.C. § 513(i), informing Congress, *inter alia*, that charitable media competes with taxable media when charitable media sells sponsorship space. *Id.*

⁸⁹ See Timothy Joyce, *The Advertising Process*, in HOW ADVERTISING WORKS 11, 13 (1998).

⁹⁰ James Crimmins & Martin Horn, *Sponsorship: From Management Ego Trip to Marketing Success*, J. OF ADVERTISING RES., July/August 1996 at 11. The au-

to achieve the same result—brand loyalty—tax law pretends as though the former does not take revenues from taxable media and therefore does not implicate UBIT.

Conventional marketing communication theory holds that consumer purchasing and brand loyalty is thought to occur through a four-step process: awareness, interest, desire, and action (AIDA).⁹¹ Under this model, marketing communication plays an informational role (making a consumer aware of a particular brand) as well as a persuasive role (creating within the consumer an interest in and desire for the brand).⁹² Though there is debate concerning the role and effectiveness of persuasion in generating brand loyalty, academicians clearly and quite naturally agree that generating awareness is the first and most indispensable part of the process.⁹³ The con-

thors provide an interesting description of the persuasive effects of sponsorship:

Sponsorship is a means of persuasion that is fundamentally different from traditional advertising. Sponsorship persuades indirectly. Sponsorship does not try to change perceptions of the brand in frontal assault. Rather, sponsorship improves the perception of the brand by flanking our beliefs about the brand and linking the brand to an event or organization that the target audience already values highly Consider the case of the consumer who believes that all oil companies are greedy despoilers of the environment and who also believes that Dr. Jane Goodall is doing heroic work preserving the natural habitat of chimpanzees. Our consumer then learns there is a close link between Conoco Oil Company and Dr. Jane Goodall The link between the lowly valued oil company and the highly valued heroine creates an imbalance that can be brought back into balance by lowering the opinion of Jane Goodall or raising the opinion of Conoco Oil Company. Since highly valued objects in our value system are often more central and more resistant to change than our brand beliefs, our consumer is likely to conclude that Conoco may not be quite as bad as the rest of the oil companies.

Id. at 12.

⁹¹ Andrew S.C. Ehrenberg, *Repetitive Advertising and the Consumer*, HOW ADVERTISING WORKS: THE ROLE OF RESEARCH 63, 67 (John Philip Jones ed., 1998).

⁹² *Id.*

⁹³ Compare *id.* at 79 (concluding that advertisement is effective only to extent it informs, but not to extent it seeks to persuade) with John Philip Jones, *Is Advertisement Still Salesmanship?*, in HOW ADVERTISING WORKS: THE ROLE OF RESEARCH 83, 87-93 (John Philip Jones ed., 1998) (concluding that advertisement is effective in informative and well as persuasive role, but implicitly conceding that generating awareness is necessary precondition to any effect).

sumer must first be made aware of the product's existence, before she is ultimately persuaded to purchase, and continue purchasing the product to the exclusion of all others. Thus, regardless of the role of persuasion, marketing communication is deemed effective only to the extent it creates "top-of-mind-awareness" of the brand (TOMA_B).⁹⁴ That is, if a consumer thinks of a particular brand in conjunction with her need for and decision to purchase a product, without any prompting or other clues, the particular brand enjoys TOMA_B and will more likely be purchased than other brands.⁹⁵ The informational function of marketing communication, then, is designed to create TOMA_B, an indispensable precursor to building brand loyalty.

Sponsorship, as a form of marketing communication, is a relatively recent phenomenon.⁹⁶ Although at one time it was viewed as a philanthropic act, sponsorship is now viewed as a form of "hard-nosed" marketing.⁹⁷ The significant facts, inso-

⁹⁴ Arch G. Woodside & Elizabeth J. Wilson, *Effects of Consumer Awareness of Brand Advertising on Preference*, 25 J. ADVERTISING RES. 41 (1985).

⁹⁵ Arch G. Woodside, MEASURING THE EFFECTIVENESS OF IMAGE AND LINKAGE ADVERTISING 19 (1996). "[T]he higher the position of a brand in a consumer's mind as measured by unaided recall, the higher the purchase intention and the higher the relative purchase of the brand." *Id.*

⁹⁶ Meenaghan, *supra* note 10, at 3. "From relatively limited activity in the late 1960's and early 1970's [commercial sponsorship] has grown substantially over the last three decades." *Id.*

⁹⁷ *Id.* at 10. "A donation mentality has been replaced by hard-nosed commercialism that is indicated by the current obsession with legal agreements, discussions on property rights and a focus on the precise returns for such investment." *Id.* The popular press, too, recognizes sponsorship's evolution from philanthropy to commercialism:

In the past, being a benefactor to the arts was an act limited to the wealthy. But modern day companies, far from being modern Medicis and Tates, take a more business-like approach to arts sponsorship. Rather than pure donations, they regard it as an important part of brand building and look for suitable returns. They expect to achieve greater recognition in the market, and improve their standing with core customers by building a rapport through the art they choose.

Emiko Terazono, *Emphasis Put On Cultural Links: Altruism Should be Allied With Marketing If Sponsorship is Not to Miss The Point*, FINANCIAL TIMES (London), June 2, 2000, at 3.

far as the theory of UBIT is concerned, are that sponsorship is the fastest growing form of marketing communication, consuming an ever-increasing size of world-wide corporate advertising budgets,⁹⁸ and exempt organizations (though they do not use the lingo of marketing theorists) are offering space in their media as an effective way to build brand awareness.⁹⁹ In addition, though, sponsorships are viewed as a form of persuasion, even in the absence of explicit requests to buy or assertions of superiority relative to other brands.¹⁰⁰ Thus, contrary to tax law's implicit conclusion otherwise, the solicitation and receipt of sponsorship revenues rather definitively implicate the fears underlying the UBIT. In effect, when charitable media solicits and receives sponsorship revenues, it is selling the same commodity, intangible though it may be, available from taxable media—brand awareness and persuasion.

The anomaly—that sponsorship revenues are not to be equated with advertising revenues and therefore taxed—is dis-

⁹⁸ The boom in sponsorships is a worldwide phenomenon, as noted in the following discussion:

Increased investment in sponsorship, while initially a feature of mature Western economies, is now evident on a global basis. The scale of world-wide growth in sponsorship . . . increased from \$2 billion in 1984 to \$16.6 billion in 1996. Europe and North America continue to dominate the world sponsorship market accounting in 1996 for 33.2 percent and 33.3 percent respectively, but other markets particularly in Australia and Asia have grown significantly.

Meenaghan, *supra* note 10, at 5. Other international scholars note sponsorship's growing market share, relative to advertising and other forms of marketing communications: "During the last decade, sponsorship spending in North America has increased at an average rate of 20 percent annually as compared to 5.5 percent and 7.6 percent for advertising and sales promotion respectively." Alain d'Astous & Pierre Bitz, *Consumer Evaluations of Sponsorship Programmes*, 12 EUR. J. MARKETING 6, 6 (1995).

⁹⁹ See, e.g., Richard L. Clarke, *The Value of Sponsorship*, HEALTHCARE FINANCIAL MANAGEMENT, June 1, 2000, at 16 (Healthcare Financial Management is official publication of Healthcare Financial Management Association, tax-exempt organization) ("[T]he act of sponsoring an event or activity with a particular audience is widely recognized as an effective way to make audience aware of the sponsor's capabilities, products, or services.").

¹⁰⁰ See *supra* note 90.

guised somewhat, and indeed the notion that exempting sponsorship revenues should have no effect on taxable media is made a bit less implausible, by requiring that the process of sponsorship be kept separate in time and place from the process of advertisement. So long as language deemed "sponsorship" is displayed or uttered separately from stereotypical advertisement, the Code indulges a false distinction—that the latter is marketing communication while the former is not. Consider the following example:

A state university conducts a well-attended, three-day track and field event each spring at an outdoor athletic facility owned by the university. The athletic facility is bounded on all sides by streets owned by the city. All of the approximately 85,000 fans attending the event over the three-day period must use one of the city streets to get to and leave the track and field event. In exchange for \$50,000, the university agrees to display the logo and products of "Cola," a well known soft drink maker. The manufacturer's logo and products are on display at and distributed from approximately 30 different places throughout the facility. In addition, the logo is affixed to the shirts and warm-up suits of all participants. The university sells the television rights to the event to a national broadcaster. In addition to buying stereotypical advertising time from the broadcaster, the cola manufacturer purchases \$20,000 worth of billboard space on the four streets bordering the facility and displays stereotypical advertisement on each billboard, and for \$40,000 it hires a blimp displaying Cola's logo and the statement, "Cola taste better than Un-Cola," to fly over the facility.

Clearly, the display of the manufacturer's logo and the distribution of its product will generate or reinforce brand awareness, and that brand awareness may be expected to increase or

maintain consumer purchasing of that brand.¹⁰¹ Likewise, the stereotypical advertisement posted on billboards just outside the athletic facility, and that purchased from the broadcaster and the blimp owner generate brand awareness and are intended to persuade, though the communication hopes to do so explicitly.¹⁰² But since the sponsorship language is kept separate from the advertising language, the law pretends they are different. Although the revenues paid to the billboard owners and the blimp owner are taxable, the law exempts the \$50,000 received in exchange for displaying and distributing the manufacturer's logo and products as part of the charitable media's time and space. The sponsorship obtained from the state university is obviously part and parcel of an overall marketing campaign, but the law will not associate the sponsorship with the advertisement so long as stereotypical advertisement is not presented contemporaneously (i.e., at the same time and place).¹⁰³ The law merely requires that the profit seeker await

¹⁰¹ See *supra* note 90 and accompanying text.

¹⁰² The research literature indicates that to get the most of its sponsorship dollar, a profit-seeker must also engage in stereotypical advertising designed to make the consumer aware that it is, indeed, a sponsor. Crimmins & Thorn, *supra* note 90, at 13.

Sponsorship, unlike advertising, involves leverage. Buying an association is only the starting point . . . [S]ponsorship without support is like buying advertisement space then having nothing to show. You end up with a blank screen or empty page. If sponsorship is to be effective it must be supported by other marketing components such as advertising, promotion, point-of-sale, on-pack signage and production of merchandise.

Des Thwaites, Rafael Aguilar-Manjarrez & Callum Kidd, *Sports sponsorship development in leading Canadian Companies: issues & trends*, 17 INT'L. J. ADVERTISING 29, 35 (1998) (citations omitted). Does this mean that charitable media really is selling something different from taxable media and that the ultimate goal—brand loyalty—is available only from taxable stereotypical advertisement? Probably not, as the data show that when persons who value a particular charitable event are made aware of a sponsor's association with that event, they increase their purchasing of the sponsor's brand. Crimmins & Horn, *supra* note 90, at 17 (showing 60 percent of U.S. adult population indicate that they try to buy company's products if company supports Olympics). Awareness and persuasion, though, can be generated simply from the display of a company's logo at the event itself, not just from follow-up advertising. *Id.* (reporting that 82 percent of adults actually attending untelevised charitable event—Chicago Gospel Festival—said they would be more likely to buy sponsor's brand).

¹⁰³ In a reversal of the original proposed regulations, the revised proposed

some other time or place (however close it may be to the time and place at which sponsorship is presented) if the sponsorship revenues are to avoid taxation.¹⁰⁴ Sponsorship revenues will never be taxed, even if the sponsorship communication is logically associated with separately presented advertising communication and, indeed, even if that advertisement is separately presented within the same charitable media or place as the sponsorship communication.¹⁰⁵ Thus, although sponsorship and stereotypical advertisement have identical effects—increasing or maintaining brand loyalty—the law exempts revenues from the former and will not impute those revenues to the latter, so long as the former is kept at a distance from the latter.

The enforcement of spatial and nonspatial distance between sponsorship and stereotypical advertisement, then, creates plausibility with regard to the notion that sponsorship revenues do not infringe upon revenues that would otherwise be paid to taxable media. In the real world, of course, it is a simple matter to observe and enforce that distance and thereby to maintain the plausibility of the tax distinction between the two marketing processes. The challenge presented by the emergence of Cyberspace, though, is that time and place are irrelevant, and distance is compressed to approximately one-tenth of one second “travel” time.¹⁰⁶ The consumer who views a profit-seeker’s sponsorship in Cyberspace need not await some other time and place to view the profit-seeker’s explicit inducement,

regulations eliminate the “tainting rule” that rendered revenues from sponsorships taxable if, within the same media, profit-seekers also presented stereotypical advertisement related to the sponsorship message. *Compare* Prop. Treas. Reg. § 1.513-4(c)(2) (original proposed regulations), 58 Fed. Reg. 5,687, 5,690 (1993) and Notice of Proposed Rulemaking, 65 Fed. Reg. 11,012-14 (March 1, 2000) (eliminating “tainting rule”). Notice of Proposed Rulemaking, 65 Fed. Reg. 11,1012, 11,014 (proposed Mar. 1, 2000). On the other hand, a “single message that contains both advertising and an acknowledgement [i.e., sponsorship] is advertising.” Prop. Treas. Reg. § 1.513-4(c)(2)(iv), 65 Fed. Reg. 11,012, 11,017 (2000). Thus, so long as sponsorship language is kept separate from advertising language, the revenues attributable to sponsorship will not be taxed.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *See supra* note 38.

particularly if that sponsorship is presented via a banner hyperlinked to the profit-seeker's web page containing an advertisement. The nature of Cyberspace, then, necessarily challenges the basis supporting the plausibility of tax law's distinction between sponsorship and advertisement.

V. LEGAL FICTION MEETS VIRTUAL REALITY

Suppose that in the real world, the state university, discussed in the preceding part, entered into an agreement whereby a soft-drink manufacturer was allowed to post a placard measuring five feet by five feet at the university's track and field event. The placard is posted on the side of a building on the grounds of the track and field facility and contains the name "Coca-Cola," painted in red and white colors, but nothing more. Directly behind the first placard, though, is another placard which says "In a national survey, two out of three respondents said Coke is better than Pepsi," and any person in attendance can turn the first placard over to read the second. Or better yet, suppose the placard is actually a door leading to a room in the building in which an audience member, having taken the affirmative step to enter, can read about Coke's superior qualities relative to other soft-drinks and can even make purchases.

As a very technical matter, we might argue that the stereotypical advertisement appearing on the second placard, and the room from which an audience member can obtain more commercial propaganda and make purchases are at separate places from the sign which says only "Coca-Cola," and, therefore, do not render revenues paid for the right to post the first placard taxable.¹⁰⁷ But in so concluding, we clearly expose the absur-

¹⁰⁷ The revised proposed regulations make two assertions that would support this statement. First, a sponsorship communication will not result in unrelated taxable income if that regulation is separate from other marketing communication constituting advertisement, even if that other communication appears in the same media as the sponsorship. Notice of Proposed Rulemaking, 65 Fed. Reg. 11,012-14 (proposed Mar. 1, 2000) (discussing rejection of "tainting rule" under which all marketing communication related to any advertisement appearing in charitable media, even if marketing communication is sponsorship, would be taxable as ad-

dity of our rule. The rule relies upon a distinction that makes no difference, particularly if in our hypothetical real world it is the norm rather than the exception that placards are merely a first step to another placard containing more information or to a separate room also containing more information. In the alternative, we might view the matter more realistically and conclude that the first placard is so indisputably connected to the second, or to the room, that it is part and parcel of the second placard or room, and therefore that the payment made to post the original placard should be taxable.¹⁰⁸

But, then, suppose that our hypothetical real world depended for its existence on the here and now, and that all other time and place was intentionally excluded. That is, in our hypothetical real world, everything is meant to be right here and right now. A rule of law that depended on the enforcement of separate time and place would either make no sense at all (i.e., the desired goal of such a rule would be completely unattainable), or would necessarily alter the manner in which those who must comply with the law interact in and with that world.

Cyberspace presents the exact issues raised in the foregoing hypothetical real world. In fact, Cyberspace *is* the hypothetical real world.¹⁰⁹ The revised proposed regulations, on

vertisement). Second, a single marketing communication that contained both sponsorship and advertisement will be taxed as advertisement:

A single message that contains both advertising and an acknowledgment is advertising. This section does not apply to activities conducted by a payor on its own. For example, if a payor purchases broadcast time from a television station to advertise its products during commercial breaks in a sponsored program, the exempt organization's activities are not thereby converted to advertising.

Notice of Proposed Rulemaking, 65 Fed. Reg. 11,012, 11,017 (proposed Mar. 1, 2000).

¹⁰⁸ The revised proposed regulations do not explain precisely how far apart a sponsorship must be from a related advertisement in order that the two not be considered a single message.

¹⁰⁹ "The Internet removes barriers of time and geography, creating a virtual 24 X 7 world." Karl Frieden, CYBERTAXATION at 8 (2000). "The Web has the facility for individuals or organisations to communicate directly with one another, regardless of distance or time." Kuen-Hee Ju-Pak, *Content dimensions of web advertising: a cross-national comparison*, 18 INT'L. J. ADVERTISING 207, 210 (1999).

the other hand, are grounded solely in the real world and intentionally exclude any mention of virtual reality.¹¹⁰ In Cyberspace, the closest equivalent to our hypothetical real world placard is a banner. Normally, banners contain hyperlinked pixel (tiny dots which form a picture)¹¹¹ that, when clicked on, cause another web page to be displayed on the viewer's monitor. Hence, the banner is like our hypothetical real world placard, behind or through which lies more information. The Service has opined, in a setting much less formal than the revised proposed regulations, that if a moving banner contains pure sponsorship but is linked to stereotypical advertisement, the connection to the advertisement will cause the banner to be considered advertisement¹¹² and any revenues paid to place the banner will be potentially taxed as UBIT. On the other hand, according to preliminary opinions, a non-moving or "static" banner containing sponsorship will not be deemed advertisement even though it, too, is linked to a web page containing advertisement.¹¹³ In yet another try, the Service has suggested that perhaps the animated nature of the banner is not determinative, but that if the banner is linked to a web page at which a commercial transaction may be complet-

¹¹⁰ "These proposed regulations do not specifically address the Internet activities of exempt organizations. However, the IRS and the Treasury Department are reviewing the application of existing tax laws governing exempt organizations, including the UBIT rules, to Internet activities." Notice of Proposed Rulemaking, 65 Fed. Reg. at 11,015 (proposed Mar. 1, 2000).

¹¹¹ Kuen-Hee Ju-Pak, *supra* note 109, at 216 (defining banners as "small hyper-linked pixel displays on a public web site.").

¹¹² "A link will retain the passive character associated with corporate sponsorship while a moving banner is more likely to be considered to be advertising." Cheryl Chasin et al., *Tax Exempt Organizations and World Wide Web Fundraising and Advertising on the Internet*, INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATION CPE TEXT FOR FY 2000, 120, 134 (1999) available via Westlaw at 99 TNT 169-20. In an earlier iteration of the rule, the Service stated somewhat confusingly, that "if it is an active or passive placard, or a running banner and income is being derived, it is advertising. If the Web page shows merely a displayed link, then it may not be advertising" Donna Moore & Robert Harper, *Internet Service Providers Exemption Issues Under IRC 501(c)(3) and 501(c)(12)*, EXEMPT ORGANIZATIONS CPE TEXT FOR FY 1999, chap. C, at 119 (1998) available via Westlaw at 98 TNT 156-17.

¹¹³ *Id.*

ed, the banner will constitute advertisement and the revenues derived from the placement of the banner will be taxable.¹¹⁴ If nothing else, these literal stops and starts indicate the difficulty of clinging to the idea of spatial and non-spatial distance as the distinction between sponsorship and advertisement in Cyberspace.

Before addressing the main issue of Cyberspace time and place, it is helpful to consider some of the demographics of Cyberspace. First, Cyberspace is increasingly populated by "seekers" rather than "browsers."¹¹⁵ The former group is thought to consist of Web users who know rather precisely what they want and, therefore, navigate through Cyberspace to web pages that are responsive to their wants. As a general proposition, seekers do not click on banners and other Web advertising.¹¹⁶ Browsers, on the other hand, are relatively

¹¹⁴ One author summarizes the Service's apparent backing-off from the distinction between static and animated banners and instead focuses on what is accessed via the banner:

Indeed the IRS appears to have evolved in its analysis based upon recent statements by IRS officials. Specifically, an IRS official acknowledged informally that links to the main page of an exempt organization's sponsors will probably not be considered advertising, even if the link contains decorative effects, such as moving or spinning. Reportedly the official . . . went on to say that if the exempt organization's acknowledgement contains a link to a Web page where business transactions could take place, the acknowledgement, whether static or otherwise, will be deemed to be advertising for tax purposes.

Cynthia F. Reaves & Jeffrey Bennett, *UBIT.COM?: Can The Old Laws Apply In The New Cyber Frontier*, 27 EXEMPT ORG. TAX REV. 251, 253-54 (2000).

¹¹⁵ David R. Fortin, "New and Improved!" *Advertising in Cyberspace: Using Conduits to Access Browsers and Seekers*, ADVERTISING AND THE WORLD WIDE WEB at 63, 65 (David W. Schumann & Esther Thorson eds. 1999).

¹¹⁶

The reasons for the falling click-through rates are relatively simple. Internet users are becoming more discriminating. They are generally not using the Internet as entertainment (like most TV, the easiest comparable), but rather as a tool to gather information, communicate, etc. Taking time out from whatever task is being pursued to click on an ad is the exception, not part of the typical user's game plan. Consumers who were once "surfers" are evolving into "searchers." The newness of the Web has also worn off, causing consumers to be less fascinated by advertising.

new to Cyberspace and are thus still fascinated by the whole concept. Browsers are more likely to click on hypertext and thus be transported willy-nilly throughout Cyberspace.¹¹⁷ In any event, the "click-through" rate, the average percentage of banners viewed that are actually clicked on, has consistently fallen from a high of around 10% to a present low of about .04%.¹¹⁸ As a general matter, then, banners rarely induce a web user to "travel" to a Web page different from the page the user is already viewing.

Despite the evolution of Cyberspace inhabitants from browsers to seekers, and the precipitously falling click-through

Morgan Stanley Dean Witter, *The e-Marketing Report*, 22 (May 2000), <<http://www.a176.g.akamai.net/7/176/770/03614ac390dcc9/www.msdw.com/techresearch/emarketing/emarketing.pdf>> (visited Nov. 15, 2000).

¹¹⁷ Fortin, *supra* note 115. The author provides the following informative summary, similar to the Morgan Stanley observation, *id.*, but uses the terms "browsers" and "seekers":

The dichotomy of user profiles has been observed by a number of researchers Browsers display serendipitous navigation patterns and hence do not actively search for information; the end result is not as critical as the entertainment and hedonic nature of the process itself for these people. Clearly, dedicated web sites and search engine ads may be less effective than "cool sites" ads for these users. Seekers, on the other hand, use a directed search approach where the ultimate goal is known *a priori* Browsers are more likely to want to spend less time reading an ad that appear and will often "click through" given that they navigate in a serendipitous sequence and that they are not pressed to find a particular piece of information. Similarly, with the introduction of search engine frames where ads appear first, the increased waiting period may be frustrating for the seeker, whose probability of click-through is very low. The same argument can be made for the presence of graphic intensive sites that deplete critical downloading time. Seekers are more likely to be annoyed by the presence of large graphic files if the purpose is strictly information-based.

Fortin, *supra* note 115.

¹¹⁸ A recent study by Morgan Stanley Dean Witter stated:

The first banners were displayed in 1994, and received a click-through rate [CTR] of about 10%. From there, it has been all downhill; [CTRs] fell to 2-3% in 1996-97. 1998 saw [CTRs] reach 1%, and as of today they have fallen even further; we estimate that today's [click-through rate] to be in the 0.4% area.

Morgan Stanley Dean Witter, *THE E-MARKETING REPORT* 24 (May 2000), available at <<http://www.msdw.com/techresearch/emarketing/info.html>> (visited Nov. 15, 2000).

rates, marketing communication in Cyberspace is increasing at unprecedented rates. In the first quarter of 2000, for example, marketing communication expenditures in Cyberspace increased by nearly 200% over first quarter 1999 amounts.¹¹⁹ More importantly, the trend in web-based marketing communication clearly points to increased spending on sponsorship rather than stereotypical advertisement.¹²⁰ One reason for this is that web users are thought to be more sophisticated than the average consumer and thus not readily spurred to action by stereotypical advertisement. In fact, web users might

¹¹⁹ *First Quarter 2000 Internet Advertising Revenues Close in on \$2 Billion*, available at <http://www.iab.net/news/content/first_qu_iab_revs.html> (visited Nov. 15, 2000). In the second quarter, 2000, advertising expenditures rose to \$2.1 billion, an increase of 127% over second quarter, 1999 spending. *Internet Advertising Revenues Pass \$2 Billion in Second Quarter 2000*, <<http://www.iab.net/news/content/adrevenue100200.html>> (visited Nov. 15, 2000). During the first and second quarter, 2000, Internet advertising spending almost equaled the total amount spent during all of 1999. *Id.*

¹²⁰ Morgan Stanley Dean Witter, *THE E-MARKETING REPORT*, at 83 (Table 72) (May 2000), <<http://www.msdc.com/techresearch/emarketing/info.html>> (visited Nov. 15, 2000). The report states that banners (which themselves might contain sponsorship language) and sponsorships make up 85% of all online marketing communication and predicts that through 2003, banners and sponsorships will continue to represent at least 70% of all online advertising. The advertising industry trade press is reporting similar trends:

Nineteen ninety-nine will mark the year that the much-maligned banner ad, in all its shapes, forms and sizes, will be superseded by "strategic" sponsorships online. These sponsorships will become the primary form of advertising on the Internet and will account for the largest share of online advertising dollars In fact, the eAdvertising Report predicts that online sponsorship in the U.S., which claimed 40% of online advertising in 1998, will experience steady growth, representing a full 58% of all online expenditures by 2001.

Heather MacLean, *Online Sponsorships to Supersede Banner Ads*, STRATEGY, 15 (Sept. 7, 1999).

According to the eAdvertising Report, published by Web research firm eMarketer, ad dollars from banner advertisements will migrate to strategic sponsorships, which claimed 40% of the online advertising dollars placed in 1998. Sponsorships will grow steadily to represent 58 percent of all online advertising expenditures by 2001. Banners won't disappear, but they will take on a less important role, the report predicts.

Beth Cox, *Report Predicts Banner Use to Decline*, INTERNET NEWS (Apr. 23, 1999) <http://www.internetnews.com/IAR/print/0,12_104121,00.html>.

even respond in a negative manner to such advertisement. Another important reason, though, is suggested by recent empirical data showing that the primary benefit of marketing communication—brand awareness—can be had without an actual click-through to a profit-seeker's Web page containing stereotypical advertisement.¹²¹ The conclusion holds true whether the marketing banner contains what would be considered advertisement under the revised proposed regulations or merely sponsorship language under those regulations.¹²²

¹²¹ Rex Briggs & Nigel Hollis, *Advertising on the Web: Is There Response Before Click-Through?* J. ADVERTISING RES. 33, 44 (March/April, 1997). The researchers randomly selected 1,232 web users who accessed a certain web page. *Id.* at 35. The users were asked to complete an online survey unrelated to the true nature of the experiment. *Id.* After completing the survey, users were returned to the web page from which they were recruited. *Id.* Each participant was returned to the exact same page as any other participant, with the exception of a marketing communication banner. *Id.* One fourth of the participants received a web page with a banner pertaining to men's apparel, one fourth received a banner pertaining to an internet service provider, one fourth received a banner relating to a web browser, and one fourth received an unbranded banner for either men's apparel, internet service provider, or web browser. Briggs & Hollis, *supra* at 44. The next day, the respondents were contacted via email and asked to respond to another survey designed to test the effect of the previous day's banner exposures. The researchers concluded from survey responses that users who were exposed to branded banners were more likely to purchase the particular brands. With regard to brand awareness the researchers concluded:

In short, click-through certainly has value (especially if the goal is to create an immediate behavioral response such as downloading software), but the click-through rate is unlikely to be indicative of the overall value of a banner exposure The Web offers unique and undeniable advantages over other media in terms of targeting and direct marketing. One such advantage is the ability of advertising banners to serve as gateways to an advertiser's own Web site. But our results suggest that the ad banner is a legitimate advertising vehicle in its own right Banner ads remind people of a brand's existence, stimulate latent and dormant brand associations, and can cause people to change their attitudes towards the brand, thus increasing their likelihood to purchase.

Id. In an even broader study, researchers found that "banner exposure itself was responsible for 96% of the brand enhancement, while a clickthrough only contributed 4%." Internet Advertising Bureau and Millward Brown Interactive, *1997 IAB Online Advertising Effectiveness Study*, at 10 (visited Nov. 2, 2000) <http://alita.mbinteractive.com/site/iab/study_formdownload.html>.

¹²² The banners used in the *1997 IAB Online Advertising Effectiveness Study*, *supra* note 120, can be viewed at <<http://www.mbinteractive.com/site/iab/ads>>. The

Thus, some marketing consultants believe that stereotypical advertising banners will soon be replaced altogether by sponsorship banners.¹²³ In fact, many well known charitable organizations, such as the Public Broadcasting Station (PBS)¹²⁴ and the National Geographic Society,¹²⁵ actively and aggressively market sponsorship opportunities on their web pages. Their marketing pitches are made almost exclusively in the language of brand awareness.¹²⁶ Finally, as a demographic matter, there is evidence that web-based marketing communication may soon evolve from the relatively inconspicuous banner mode, to a marketing communication that is automatically presented to a web user while she is waiting for her target media to appear on her monitor. These "interstitials"¹²⁷ and

viewer will note that four of the twelve banners involved in the study would likely qualify as sponsorship. Compare the banners for Cigar Aficionado, Kenwood, Toyota, and Schick with the definition of sponsorship under the revised proposed regulations. *See supra* note 83.

¹²³ *See MacLean supra*, note 120.

¹²⁴ *See* <http://sponsorship.pbs.org/online_only_benefits.htm> (visited Nov. 20, 2000). PBS' online sponsorship solicitation states:

PBS.org offers you a variety of ways to reach your target audience through innovative sites, channels, and publications. When you sponsor PBS.org sites, your logo appears with a hyperlink to your own Web site, making your sponsorship a powerful marketing tool that contributes directly to your bottom line. By providing both sponsorship and banner opportunities, PBS.org offers exciting ways to strengthen your corporate image and meet your goals.

<http://sponsorship.pbs.org/online_only_opps.htm> (visited Nov. 20, 2000).

¹²⁵ The National Geographic Society's web page states:

nationalgeographic.com showcases your brand like no other site on the Web, positioning your product among the highest quality editorial and some of the world's most renowned images. The site's audience is overwhelmingly well educated and affluent, and traffic continues to grow exponentially, according to Media Metrix. The site is audited by the Audit Bureau of Circulation (ABC). Demographic and psychographic information is available from @plan.

<<http://www.nationalgeographic.com/about/advertising.html>> (visited Nov. 20, 2000).

¹²⁶ *See supra* notes 124-25.

¹²⁷ "Interstitials are large, nearly full-screen ads that often appear on browsers as a new page is loading. Obviously this works best when the page being loaded is heavy on graphics or movement, forcing it to load more slowly." Morgan Stanley Dean Witter, *supra* note 120, at 83.

"superstitials"¹²⁸ are usually smaller than, and appear on top of, the web page to which the user is destined. Significantly, the user must execute a mouse click to make the marketing communication go away and thereby to view her intended web page.¹²⁹ Thus, although the communication is intended to be polite and relatively unintrusive, it nevertheless demands the user's attention at least for the period of time it takes the user to make the communication go away.

With an understanding of web demographics in hand, we can proceed first to a consideration of the Service's tentative conclusions regarding whether a banner otherwise containing sponsorship language should be considered advertisement by virtue of its link to a page that is undoubtedly advertisement. After that, we consider the whole notion that sponsorship may be distinguished from advertisement in Cyberspace—a timeless and place-less realm—by enforcing time and place separations between the two forms of marketing communication. Completion of either task leads to a sense of utter futility, arising from the realization that the real world rules, by which a rather dubious distinction between sponsorship and advertisement is enforced, are simply illogical and irrelevant in Cyberspace.

The first proposal—that a banner containing sponsorship language but linked to a web page containing advertisement should be deemed advertisement if the banner is animated—ignores the essential problem. Instead of focusing on the near identity of time and place as between the sponsorship and the advertisement, the proposal apparently focuses on the likelihood that the web user will click on the banner. To put the matter in terms of our real world hypothetical, the proposal focuses on the likelihood that a viewer of the first placard will turn to the second placard or will enter the room directly behind the first placard.

¹²⁸ A superstitial is "another version of an interstitial, although not necessarily a larger one. These are often animated and sometimes contain interactive features like games. Users may click on a corner to remove the super/interstitial." Morgan Stanley Dean Witter, *supra* note 120, at 84.

¹²⁹ *Id.* More recent versions of super/interstitials simply go away on their own unless the user clicks on the advertisement.

The reasoning seems related to the idea that if a viewer is unlikely to click through to the profit-seeker's advertisement page, the profit-seeker could not possibly be buying advertisement in competition with taxable media. The problem, of course, is that the proposal is based on assumptions that are faulty on several levels. First, sponsorship banners are effective means of marketing communication in Cyberspace even if the web user does not click on the banner.¹³⁰ The empirical data suggests that most of the intended effect is obtained simply from the banner itself, without an actual click-through. Second, the reasoning conceptualizes the web user as a sort of easily trained and manipulated actor who can be induced to exhibit certain behavior by the display of bells and whistles. The evidence, instead, is that web users are self-regulated seekers with defined purposes in Cyberspace. They go to particular sources and very rarely click on banners of any sort. Certainly, the evidence suggests that a web user's click-through is motivated by the user's own volition, rather than a sort of Pavlovian programmed response to stimuli appearing in the banner.¹³¹ Regardless, the implication that users are often induced to click on a banner will quickly be overcome by the progress of technology and by the web's migration from banners to interstitials, and superstitials, which not only attract, but require, a web user's attention and action. Hence, a distinction between sponsorship advertisement based upon a banner's ability to attract a web user's attention and from there induce a click-through is entirely unresponsive to the question of whether a sponsorship banner linked to an advertisement page is itself advertisement.

The second proposal—that a banner containing sponsorship language but linked to a profit-seeker's web page from which the web user can actually complete a transaction—more direct-

¹³⁰ See *supra* note 121-22 and accompanying text.

¹³¹ "Another distinctive characteristic is that exposure to advertising is largely controlled by the audience; the audience look for the marketer or the advertisement it wants to be exposed to rather than vice versa." Kuen-Hee Ju-Pak, *supra* note 109, at 210.

ly addresses the relevant issue. Under this proposal, the connection directly from a sponsorship page to a direct marketing web page is apparently too close to ignore. But the proposal seems artificially under-inclusive. Advertisement as defined in the revised proposed regulations includes more than language ultimately necessary to complete a commercial transaction.¹³² If a link to a direct marketing page is too close to ignore, so too is a linked page that contains stereotypical advertisement though not an actual order form. In fact, the proposal seems only to create the incentive for the placement of an intermediary page between the sponsorship banner and the final transaction page. Regardless, it seems unlikely that a profit-seeker would link its sponsor banner directly to an order form. It is more likely that a sponsor banner would be linked to a web page containing stereotypical advertisement for a particular product or range of products (showing the consumer exactly what she may purchase), with that page containing an "order here" link to another page. Thus, the second proposal, though it directly addresses the issue of how the law should characterize a sponsorship banner that directly connects to a web page containing advertisement, is too narrowly drawn to be of any real consequence or to result in any real enforcement of the time and place concept.

Indeed, the whole notion that the law should tax sponsorship communications in Cyberspace if the banner containing that communication is linked to a web page containing advertisement seems overly formalistic, especially considering that

¹³² Prop. Treas. Reg. 1.513-4(c)(2)(iv), 65 Fed. Reg. 11,012, 11,017 (March 1, 2000).

For purposes of this section, the term *advertising* means any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product.

Id.

the revised proposed regulations specifically allow the listing of a profit-seeker's web address without taxation.¹³³ Thus, a sponsorship banner may contain the name "Coca-Cola" along with the web address, "www.coke.com" and not implicate UBIT if the banner is not linked to the stated web address. But clicking on a hyperlinked banner is merely a substitute for actually typing the address and thereby being transported to the web site. Since Cyberspace is populated mostly by seekers who are not induced to action by bells, whistles, or even hyperlinked text (the click-through rate being close to zero percent), whether a banner containing a web address is hyperlinked should have no effect on the probability that the web user will visit the profit-seeker's site containing advertisement. It should not matter at all whether a web user types a web address or simply clicks on a banner. The web user will go, or not, depending on her own needs and inclinations. That is, allowing the presentation of a profit-seeker's web address, but not allowing the use of hyperlinked text to that address, will make no difference to a web user, if the web user is already inclined to travel to the profit-seeker's advertising site. The difference in tax consequence is one related to form rather than substance and, therefore, does not address or further any tax policy.

A final irony related to the media of the new millennium is that a rule of dubious validity in the real world will hasten the onset of the feared real world consequences in Cyberspace (assuming those consequences really are likely to occur). It was more than obvious almost forty years ago that sponsorship was as much a tool of marketing communication as advertisement. If the premise of UBIT is true, exempting sponsorship revenues from taxation while taxing advertisement revenues will not eliminate the market distortion caused by tax exemption because charities can sell the same commodity—marketing communication space—for less than the price at which that commodity may be had from taxable media. Profit-seekers are increasingly spending their marketing communication budget

¹³³ See *supra* note 87 (stating specifically that listing sponsor's Internet address is within definition of qualified sponsorship).

on sponsorship rather than on stereotypical advertisement. The final irony, then, is that to protect against the feared UBIT consequences, the law should tax sponsorship communications appearing in charitable Cyberspace media and exempt revenues from stereotypical advertisement.

VI. CONCLUSION

In her concurring opinion in *Reno v. American Civil Liberties Union*, Justice O'Connor accepted and adopted the strange idea that Cyberspace can be divided into zones, much like a municipality can be divided into zones separating residential areas from commerce and industry.¹³⁴ Her argument was that various media in Cyberspace occupy "fixed locations on the Internet."¹³⁵ If that were true, there would be some hope in the effort to maintain the plausibility that sponsorship and advertisement in Cyberspace must be kept separate in order not to equate the two. The law could simply assign certain separate and fixed locations, sufficiently far apart, for sponsorship and advertisement. The idea of fixed locations, though, just doesn't apply in Cyberspace. Media in Cyberspace may have been created "over there" but once published in Cyberspace, that media is always "right here" according only to the user's demand. A church in Cyberspace is just as much right next to a red light district as it is to a library. The problem with Justice O'Connor's conceptualization, and indeed any effort to enforce spatial and nonspatial distance in Cyberspace, is that it fails to account for the fact that Cyberspace exists as each individual web user interacts with it. As long as users exercise individual volition, time and place will be irrelevant in Cyberspace. Each individual user can keep one media—sponsorship—as close to, or as far from, another media—advertising—as she pleases.

Recognizing the irrelevancy of time and space in Cyberspace—the fallacy of zones or fixed locations in

¹³⁴ 521 U.S. 844, 890-891 (O'Connor, J., concurring).

¹³⁵ *Id.* "Cyberspace undeniably reflects some form of geography; chat rooms and Web sites, for example, exist at fixed 'locations' on the Internet." *Id.* at 890.

Cyberspace—leads directly to the first observation concerning the distinction between sponsorship and advertisement there. That distinction simply cannot be made on the basis of a rule that seeks to enforce a distance between the two. Sponsorship relating to a particular brand or product will always be as closely connected with, or as distant from, advertisement for the same brand as the user pleases. Such is the very nature of Cyberspace.

The Service might still seek an objective means of distinguishing sponsorship from advertisement, however implausible that distinction really is. But to do so, the Service must attack the nature of Cyberspace itself, or at least charitable media's existence in Cyberspace. Since one media is right next to any other in Cyberspace, because of the wonder of hyperlinks, the Service could maintain a time and place distinction only by enforcing a ban on links from a sponsorship communication to an advertising communication. And since a hyperlink is nothing more than a shortcut for the user who might otherwise be inclined (regardless of any bells and whistles) to type the web address for the page containing the advertisement, the rule would also have to require that a sponsorship communication not include the sponsor's web address. In this manner, and only in this manner, the Service could impose and enforce a time and space dimension in charitable Cyberspace. In effect, a user would never be able to get there (to advertisement) from here (from sponsorship).

The consequence of such a rule seems analogous to confining charitable radio broadcasts to AM frequencies while the rest of the world utilizes FM frequencies, but only insofar as the broadcast relates to a profit-seeker's marketing goals. Charitable media could link to various other media without fear of taxation and therefore would not be entirely confined to an AM version of Cyberspace. Perhaps that qualifier serves to ameliorate whatever negative consequences that would result from such a rule. Still, there is something difficult to articulate, but nevertheless disquieting, about encouraging, through taxation, the severing of hyperlinks between communications in Cyberspace.

If that lingering feeling of discontent were to prevail, the Service would have but one other option. Once it is accepted that time and place are irrelevant in Cyberspace—that everything is right here and right now—the idea of enforcing fixed locations for sponsorship sufficiently apart from advertisement must necessarily be abandoned. Time and place are anathema to Cyberspace, and so relying on those concepts is futile. A banner or other form of communication appearing on a web page must instead be judged sponsorship or advertisement at face value and without regard to the linking of that banner to some other communication.

Recall that the fears motivating UBIT are unlikely to materialize in the real world and even less so in Cyberspace. If intellectual honesty leads to the acceptance of the notion that charitable hegemony is about as likely as a world without Cyberspace, then settling on the second option would not be such a monumental decision. Exempting revenues derived from sponsorship communications in Cyberspace, even though that communication is like the real world placard, directly behind which is advertising, should have a nearly imperceptible impact on all other activities in Cyberspace. The impact would not be completely imperceptible though. A set of ineffective but invariably bothersome regulations would be noticeably and thankfully absent.

COMMENTS

PROPOSALS FOR A FEDERAL PROHIBITION OF INTERNET GAMBLING: ARE THERE ANY OTHER VIABLE SOLUTIONS TO THIS PERPLEXING PROBLEM?*

I. INTRODUCTION

Unquestionably, gambling has a powerful economic hold on many states, as gambling is now legal in some form in forty-eight of the fifty states.¹ Consequently, more and more Americans are beginning to view gambling as a form of entertainment rather than as a vice.² Likewise, all varieties of gambling are a major attraction for the American public, as over one-half of American households are reported to have visited traditional casinos in 1995.³ Revenues from non-

* Earl T. Thomas Award for Excellence in Writing, presented annually by the law firm of Alston & Jones of Jackson, Mississippi.

¹ John T. Fojut, *Ace in the Hole: Regulation of Internet Service Providers Saves the Internet Gambling Prohibition Act of 1997*, 8 DEPAUL-LCA J. ART. & ENT. L. 155, 155 (1997). Only Hawaii and Utah do not allow some form of gambling. *Id.*

² Scott M. Montpas, *Gambling On-line: For a Hundred Dollars, I Bet You Government Regulation Will Not Stop the Newest Form of Gambling*, 22 U. DAYTON L. REV. 163, 166 (1996). Additionally, the states themselves are beginning to encourage their citizenries to gamble; for instance, New York spent \$41 million advertising its state-sponsored lottery in 1995. *Id.*

³ Mark G. Tratos, *Gaming on the Internet*, 3 STAN. J.L. BUS. & FIN. 101, 102

Internet gambling alone were nearly \$550 billion in the United States in 1996.⁴ Therefore, it was almost inevitable that gambling would become terrifically intertwined with the Internet, as that communication medium provides "relative immunity from the legal burdens of the non-Internet world,"⁵ including taxation, censorship, and widespread government regulation, and does not even require a person to leave the convenience of his or her own home to wager substantial sums of money.⁶ Currently, a potential gambler can wager on all

(1997). Americans legally gambled more than a half a trillion dollars in 1996. Michael Krantz, *Cyberspace Crapshoot: The Imminent Boom of On-Line Gambling Raises a Host of Dicey Moral and Jurisdictional Issues*, TIME, June 2, 1997, at 61. Likewise, an Associated Press Study in 1993 found that half of all Americans had wagered on sporting events in that year. Ante Z. Udovicic, *Special Report: Sports and Gambling a Good Mix? I Wouldn't Bet on It*, 8 MARQ. SPORTS L.J. 401, 402 (1998). Gambling analysts predict that by later this year, nearly ninety-five percent of Americans will live within four hours of a traditional casino. James Popkin & Katia Hetter, *America's Gambling Craze*, U.S. NEWS & WORLD REP., Mar. 14, 1994, at 42-43.

⁴ Stevie A. Kish, *Betting on the Net: An Analysis of the Government's Role in Addressing Internet Gambling*, 51 FED. COMM. L.J. 449, 452 (1999). The first virtual casino, Internet Casino, Inc., was opened in August of 1995. Jenna F. Karadbil, Note, *Casinos of the Next Millennium: A Look into the Proposed Ban on Internet Gambling*, 17 ARIZ. J. INT'L & COMP. 413, 415 (2000). By the following year, there were more than two hundred Internet wagering sites. *Id.*

⁵ Peter Brown, *Regulation of Cybercasinos and Internet Gambling*, 547 PLI/PAT. 9, 11 (1999). Additionally, the number of websites appear to be increasing at a rate of at least 65,000 per hour. Claire A. Koegler, *Here Come the Cybercops: Betting on the Net*, 22 NOVA L. REV. 545, 546 (1998). In 1997, \$600 million in revenue was generated on Internet sports gambling alone, and it is predicted that revenues generated from that source were \$10 billion in 2000. Jack Goldsmith, *What Internet Gambling Legislation Teaches Us About Internet Regulation*, 32 INT'L LAW. 1115, 1116 (1998). By 2006, liberal estimates are that online gambling could generate \$100 billion a year in revenues. Debra Baker, *Betting on Cyberspace: When It Comes to the Future of Internet Gambling, All Wagers Are Off*, A.B.A. J., Mar. 1999, at 54-55. Currently, it is estimated that there are 700 Web sites available to accept wagers and 1.4 million Americans gamble online. Steve Tetreault, *Internet Gambling Ban OK*, THE LAS VEGAS REV. J., Nov. 20, 1999, at 1A.

⁶ Kish, *supra* note 4, at 452. On the other hand, Internet gambling sites are relatively easy to set up and operate, as "[a]ny computer-savvy person could set up a gambling site in a matter of hours on one's own personal computer." Karadbil, *supra* note 4 at 415. Likewise, only a small number of employees are needed to man such an online casino, while the total labor force at a traditional casino could reach into the hundreds of workers. *Id.* at 416. As a result, the total

sorts of virtual gambling, including lotteries, sports, and nearly any kind of traditional casino gambling imaginable.⁷

The growth of this new gaming medium has not gone unnoticed by the United States Congress.⁸ The Federal Wire Act criminalizes the use of wire communications in placing sports wagers between states or between states and foreign countries, though it is unclear whether this legislation, originally passed in the 1960s, is fully applicable to the recent advent of the Internet and its ever-changing nature.⁹ Hence, on July 22, 1998, Senator Jon Kyl (R.-Ariz.) introduced federal legislation, the Internet Gambling Prohibition Act (the "IGPA"), designed to amend the Federal Wire Act and make it clearly applicable to Internet gambling.¹⁰ While this legislation has since taken many meandering turns and has not passed both houses of Congress, its likely passage poses many troublesome issues which will be dealt with in this comment.

After a brief description of how such gaming is transacted, I will discuss how the possible takeover of this broad area of regulation by the federal government of a subject matter which has historically been dealt with primarily by the states presents troubling questions for the balance of traditional federal-state relations. Closely related to this issue is the question of whether the passage of the IGPA would constitute an overstepping by Congress of its Commerce Clause powers. This comment will also address First Amendment concerns implicated by the potential passage of the IGPA, as well as

revenue needed to start up an advanced Internet gambling site is probably only a few million dollars, whereas similar startup costs for a traditional casino could reach into the hundreds of millions. *Id.* at 415.

⁷ Kish, *supra* note 4, at 452. Some observers have even predicted that in the very near future these "sites could offer virtually every conceivable form of gambling—political election wagering and armed conflict wagering to name a few possibilities." Fojut, *supra* note 1, at 158.

⁸ Justin Matlick, Editorial, *Gamblers Will Surf Around Any Electric Blockade*, THE LAS VEGAS REV. J., October 28, 1999, at 9B.

⁹ Tetreault, *supra* note 5, at 1A.

¹⁰ Brown, *supra* note 5, at 22. Senator Kyl first proposed the legislation as an amendment to the Crime Prevention Act of 1995. I. Nelson Rose, *Gambling and the Law: Internet Gambling: Statutes and International Law*, SE81 A.L.I.-A.B.A. 231, 234 (2000).

discuss whether the Internet, given its complex nature, can ever be fully prohibited or even slowed down by the passage of the IGPA. Finally, I will end with a brief conclusion about what steps state governments and/or the federal government should undertake to regulate the unchecked growth and expansion of Internet gambling.

II. THE NATURE AND FORM OF INTERNET GAMBLING

In order for one to engage in Internet gambling, it is first necessary to visit one of the hundreds of Internet sites devoted to that activity and to establish some form of credit account.¹¹ Typically, one must open such accounts with the virtual casino operator's bank, which the operator may then access.¹² After these initial formalities, the gambler may come and go at his leisure, and upon each subsequent visit to the site, the gambler must enter his password and log-in, whereupon he may gamble on any of the games that the particular site offers.¹³ Should the player lose a hand of blackjack, for example, the amount wagered will be automatically deducted from his account.¹⁴ Should the player win his hand of blackjack, the amount wagered will either be credited to the user's account, or mailed to the player's physical address in the form of a check.¹⁵

¹¹ Goldsmith, *supra* note 5, at 1116. A few sites, instead of allowing the gambler to simply access the website by typing the address, require the gambler to install software that must be downloaded before the player can begin wagering; even so, the gambler must still be online in order to access the desired games. Karadbil, *supra* note 4, at 417.

Some sites require that "real money," either in the form of an electronic wallet or a credit card, be used; others allow gamblers to wager with chips that may or may not be redeemable for cash value. Brown, *supra* note 5, at 12. The latter type of sites usually garner their revenues from the use of membership fees that have nothing to do with the amount wagered. *Id.* Each of these types of sites requires that credit card information be submitted in order to create a password and log-in name, and that there be some minimum amount wagered. *Id.* at 12-13.

¹² Tratos, *supra* note 3, at 111.

¹³ Fojut, *supra* note 1, at 159.

¹⁴ *Id.*

¹⁵ *Id.* at 159-60.

Nearly without exception, these Internet gambling operations are located outside of the continental United States, often in small Caribbean nations where most or even all forms of gambling are legal.¹⁶ As a result, “[u]nlike traditional gambling activities, such as Las Vegas casinos or state-run lotteries, which are highly regulated by state gaming commissions, Internet gambling, for the most part, exists without any significant regulation.”¹⁷

III. FEDERAL-STATE RELATIONS IN THE AREA OF GAMBLING

A. *Traditional Gambling Policy and State Concerns with Internet Gambling*

Traditionally, the federal government has yielded to the wishes of the individual states in their determinations of how and when gambling should be allowed to exist, with the avowed policy rationale that such a relationship constitutes “a better method for capturing the will of the people.”¹⁸ Moreover, courts have regularly recognized that gambling policy should be reserved to the states pursuant to the Tenth Amendment of the United States Constitution.¹⁹ As a result,

¹⁶ Brown, *supra* note 5, at 13. Legal gambling websites can also be found throughout Europe, including Austria, Belgium, Germany, Finland, and Liechtenstein. Tom W. Bell, *Gambler's Web*, REASON, Oct. 1, 1999, at 26. A total of twenty-four countries have authorized some form of Internet gambling. Michael P. Kailus, Note, *Do Not Bet on Unilateral Prohibition of Internet Gambling to Eliminate Cyber-Casinos*, 1999 U. ILL. L. REV. 1045, 1047 (1999).

¹⁷ Kish, *supra* note 4, at 453. This facet of the Internet is hardly accidental, as the forerunners of the Internet were first devised by members of academia in the 1960s to aid the American military-industrial complex in the Cold War. David I. Gold, Comment, *Internet Gambling Debt Liability: Trouble Ahead? A Consideration of Providian v. Haines*, 22 T. JEFFERSON L. REV. 219, 220 (2000).

¹⁸ Kish, *supra* note 4, at 450. This policy was explicitly stated by the 1976 Commission on the Review of the National Policy Toward Gambling. *Id.*; see also *Internet Gambling, 1999: Hearings on S. 692 Before the Judiciary Subcomm. on Tech. and Terrorism*, 106th Cong. (1999) (statement of Betty Montgomery, Ohio Attorney General) (explaining gambling policy has been regulated primarily by states, and such policies vary more from state to state than almost any other area of law).

¹⁹ Brown, *supra* note 5, at 14. The Tenth Amendment provides that “[t]he powers not delegated to the United States by the Constitution, nor prohibited by

gambling in nearly every imaginable form and variety has sprung up in each of the various states.²⁰ Taken as a whole, the combined approaches of the various states indicate a strong preference in favor of the legalization of gambling.²¹

The growth of legalized gambling in the various states is in large part motivated by the concerns of state and local

it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X. A further explanation is that the individual states should be allowed to "determine whether and what type of gambling activity will be legal within their borders as such a decision is thought to be a part of their police power obligation to promote the health, safety, and welfare of their citizens." Kish, *supra* note 4, at 457.

This deference in favor of the states regarding setting gambling policy has not been without limitations however. For example, Congress, with an eye toward confining the interstate effects of the notorious Louisiana Lottery of the late 1800s, banned all lottery material from the mails in 1890 and, in 1895, banned all lottery materials from passing in interstate commerce. Ronald J. Rychlak, *Lotteries, Revenues, and Social Costs: A Historical Examination of State-Sponsored Gambling*, 34 B.C. L. REV. 11, 42-44 (1992). The Louisiana Lottery, at the time, made annual profits of up to \$13 million, and winning tickets were said to be "accepted everywhere in the country as the equivalent of a certified check." *Id.* at 41-42. The United States Supreme Court subsequently upheld the constitutionality of both laws. *Id.* at 43. See generally *Champion v. Ames*, 188 U.S. 321, 363 (1903) (upholding ban on lottery materials passing through interstate commerce); *In re Rapier*, 143 U.S. 110, 134 (1892) (upholding constitutionality of Congressional ban of lottery materials in mail). These events marked an end to state-sponsored gaming through the mid-1960s. Rychlak, *supra*, at 44. For a discussion of current Commerce Clause jurisprudence and the substantial pitfalls it may pose for the IGPA, see *infra* part IV.A.

²⁰ These state-sanctioned gambling practices have included riverboat casino gambling, state-run lotteries, horse racing, bingo, and charity gaming, just to name a few. Kailus, *supra* note 16, at 1050. At one extreme are Utah and Hawaii, which allow no gambling within their territorial jurisdiction. See *supra* note 1 and accompanying text. At the other extreme is Nevada, home of the gambling capital of the world, Las Vegas. Kailus, *supra* note 16, at 1050. Recent Gallup opinion surveys indicate that eighty percent of Americans feel that gambling, in at least some variety, should be legalized. *Id.*

²¹ *Id.* However, some commentators have argued that there may currently be something of a public backlash against legalized gambling, apparently based on the perception that gambling has created more poverty and urban blight than it has alleviated. Tratos, *supra* note 3, at 104.

Indeed, until the latter part of the twentieth century, gambling was considered immoral by nations where games of chance, particularly when carried out at luxurious casinos, have long been viewed as the social trappings of the aristocracy.

governments with the steady and often extravagant amounts of tax revenue that legalized gambling can and does provide.²² In turn, most states have gaming commissions which thoroughly regulate the gaming activities within their borders, including, for example, refusing to license any game "for play unless the gaming authority knows precisely the odds and, as a corollary, the house advantage of the game."²³

As state and local governments continue to thrive on this symbiotic relationship with the various gaming industries they allow, it is only natural that they are none too happy about the advent of Internet gambling, which by its very nature is decentralized and accessible to a wide geographical distribution of diverse users.²⁴ Hence, the Internet "has created an outlet for sports gambling as well as casino style gambling far beyond what a local bookie can offer and far less expensive than a vacation to Reno."²⁵

Whereas state gaming commissions "closely regulate not only the operators themselves, but also the method and manner in which the games are played[,] . . . [i]n the limitless

²² John E. Hogan, *World Wide Wager: The Feasibility of Internet Gambling Regulation*, 8 SETON HALL CONST. L.J. 815, 816 (1998). Obviously enough, gambling also provides huge corporate earnings and provides many persons with employment. Montpas, *supra* note 2, at 166-67.

²³ Tratos, *supra* note 3, at 111; see also Anthony Cabot, *Internet Gambling in the Information Age*, 7 NEV. LAW. 20, 21 (1999) (explaining that "[s]trong government oversight helps assure patrons that the games are fair and honest, that a fair forum exists for resolution of disputes with the operator, and that winnings will be paid promptly.").

²⁴ Brown, *supra* note 5, at 11. "It is 'no exaggeration to conclude that the content of the Internet is as diverse as human thought.'" Reno v. ACLU, 521 U.S. 844, 852 (1997). From a speaker's point of view, "it constitutes a vast platform from which to address and hear from a worldwide audience of millions of readers, viewers, researchers, and buyers." *Id.* at 853. The Internet, having its very origins in academic research, appears "inherently resistant to any form of censorship or regulatory structure." Tratos, *supra* note 3, at 114. Additionally, since many of the site operators are located abroad, the revenues to be made from such gambling will be taxed by foreign governments. Goldsmith, *supra* note 5, at 1116; see also *supra* notes 16, 17 and accompanying text.

²⁵ Hogan, *supra* note 22, at 816. The Internet also allows a potential gambler to avoid the "reputational sanctions that might accompany gambling in a public place." Goldsmith, *supra* note 5, at 1116.

confines of cyberspace . . . no such regulatory scheme exists."²⁶ By regulating and possibly criminalizing Internet gambling, state and local governments could (in theory at least) preserve the steady flow of tax revenues they receive from the legal gambling establishments which they do permit by forcing potential gamblers to patronize such establishments.²⁷ Not surprisingly, legislators from states with strong pro-gambling policies are often the biggest supporters of initiatives to prohibit Internet gambling.²⁸

In addition to the selfish concerns of state governments with the potential for rapidly dwindling tax revenues, there are also other lurking specters with which they should clearly be concerned. The foremost concern seems to be the potential for consumer fraud in a variety of circumstances.²⁹ For example, Las Vegas slot machines usually are required to pay back from 90% to 98% of all of the money played; in cyberspace, however, there is no regulatory regime to impose such a requirement.³⁰ With Internet gambling, the house develops and manipulates the odds without oversight from any regulatory body, and the house controls the account of the player.³¹

²⁶ Tratos, *supra* note 3, at 111.

²⁷ Fojut, *supra* note 1, at 163; *see also* Brown, *supra* note 5, at 14-15 (explaining Internet gambling fouls up state legislative purposes "by funneling jobs and revenue to private persons who are usually out-of-state (and often out-of-country)."). It has been forcefully argued that by allowing widespread gambling and even promoting it in many circumstances, the "states have shifted from a position of moral-based legislation to a posture of self-serving regulation." Kailus, *supra* note 16, at 1070.

²⁸ Kailus, *supra* note 16, at 1069. Currently, Nevada, Louisiana, Michigan, and Illinois all *expressly* make it illegal to accept gambling wagers via the Internet. Rose, *supra* note 10, at 234.

Traditional casino operators are currently left in an unusual dilemma as they clearly want to stop the exponential growth of their newest competitors, yet they also would like to make profits on Internet gambling themselves should the opportunity arise. Kailus, *supra*, at 1066-67. Although the American Gaming Association, the major trade association for the gambling industry, has waffled on the issue, many traditional casinos are currently exploring their Internet growth potential. *Id.* at 1067.

²⁹ Tratos, *supra* note 3, at 111.

³⁰ *Id.*

³¹ *Id.* at 112. Further, states regularly allow licensed casinos to forbid gam-

Hence, there are real concerns that the odds on the various games are rigged in favor of the house, and that even if the player *does* win his game, he will not be paid.³² Additionally, there is the concern that even if the gambling website is itself honestly run, computer hackers may intercept the gambler's credit card or other financial information.³³

A second strong state concern is that Internet gambling may pose a potential for addiction even greater than that associated with traditional gambling activities.³⁴ Because many persons who might not be willing or able to gamble otherwise are attracted to the video game aura surrounding Internet gambling, it has been termed the "crack cocaine of gambling."³⁵ The gambler is not even required to leave the

bling by drunks, gambling addicts, and minors; obviously enough, Internet gambling sites easily "elude these safeguards In most instances, the individual gambler does not [even] know, or have the resources to determine, who exactly the Internet 'house' is" Bruce P. Keller, *The Game's the Same: Why Gambling in Cyberspace Violates Federal Law*, 108 YALE L.J. 1569, 1591-92 (1999).

³² John Bigness, *Companies Place Bets on Internet Gambling*, CHI. TRIB., Aug. 25, 1997, at 1. Senator Harry Reid of Nevada has poignantly observed that "[a]nyone who gambles on the Internet should go see a psychiatrist How in the world anyone could think they can guarantee a fair game on the Internet is beyond my ability to comprehend." Tetreault, *supra* note 5, at 1A. Should the house lose consistently, a gambling website operator might choose simply to shut down their site and run. *Internet Gambling Subcomm. Markup, 1999: Hearings on H.R. 3125 Before the Subcomm. on Crime of the House Comm. of the Judiciary*, 106th Cong. (1999) (statement of Bill McCollum, Chairman of the Subcomm.). Operators of Internet gambling sites have vigorously protested that any impropriety will be cured by the marketplace, as gamblers will only place their bets with "honest" operators. Montpas, *supra* note 2, at 172.

³³ Fojut, *supra* note 1, at 160.

³⁴ *Id.* at 161. Often associated with this perspective is the well-organized "religious right." Tratos, *supra* note 3, at 104. Lori Rugle, the deputy director of the Addiction Recovery Center of the Brecksville Virginia Medical Center estimates that three percent of the American populace, or roughly nine million persons, are compulsive gamblers. Udovicic, *supra* note 3, at 401.

³⁵ Kish, *supra* note 4, at 453. This video game aura might also be compared to that surrounding video gambling. See Ronald J. Rychlak, *Video Gambling Devices*, 37 UCLA L. REV. 555, 566 (1990) (tracing roots of present-day video gambling to video game boom of late 1970s). These video gambling devices differ from traditional video games in that practice will not improve performance, and the excitement associated with playing the game "comes from the possibility of winning money." *Id.* The social consequences of such video gambling have included a

comfort of his own home and thereby realize the magnitude of an extensive monetary loss that might otherwise be brought home by a trip to a traditional casino.³⁶ For example, "[a]s the pile of chips grows or shrinks [in a traditional casino], gamblers are constantly reminded that they are losing their own money. On the Internet, there is no similar sensation because there is no tangible representation of money."³⁷ There also appears to be a widespread fear that children will be exposed to Internet gambling.³⁸

marked growth in the number of compulsive gamblers, often among children and other groups that have not traditionally been problem gamblers. *Id.* at 577. Additionally, the time line in which persons "hit bottom" has been reduced from as much as fifteen years with traditional gambling activities to as little as a few months with video gambling. *Id.*

³⁶ Kish, *supra* note 4, at 453. This detached atmosphere might be particularly damaging to persons who are *already* gambling addicts. Fojut, *supra* note 1, at 162; see also Montpas, *supra* note 2, at 172 (noting that detached atmosphere of Internet gambling sites lacks powerful "disincentive that prevents a person from gambling beyond [his] means."). Bernard Horn of the National Coalition Against Gambling Expansion has argued that "[b]ecause of the privacy of an individual at his/her computer terminal, addicts can destroy themselves without anyone ever having the chance to stop them." *Internet Gambling Prohibition Act, 1998: Hearings on H.R. 2380 Before the Subcomm. on Crime of the House Comm. on the Judiciary*, 105th Cong. (1998). Advocates of a ban on Internet gambling warn that "[a]ddicts could literally click their mouse and bet the house." Kish, *supra* note 4, at 453.

³⁷ Fojut, *supra* note 1, at 162.

³⁸ *Id.* at 161. In particular, children could potentially become targets of unscrupulous gambling website operators, because "widely dispersed electronic betting machines . . . tempt teenagers already fond of video games . . . and since children often know more about computers than their parents, children are capable of circumventing their parents' control." *Id.* at 161-62 (alteration in original). Jeff Pash, the Executive Vice President of the National Football League, has also explained that sports betting in general is already a mounting problem among teenagers and college students, and "[a]s the Internet reaches more and more school children, Internet gambling is certain to promote even more gambling among young people. Because no one stands at the door of the virtual casino checking I.D.s, our children have the means to gamble on the family computer after school." *Internet Gambling, 1997: Hearings on S. 692 Before the Subcomm. on Tech., Terrorism, and Gov't Info. of the Senate Judiciary Comm.*, 105th Cong. (1997); see also *Internet Gambling, 1999: Hearings on S. 692 Before the Subcomm. on Tech. Terrorism, and Gov't Info. of the Senate Judiciary Comm.*, 106th Cong. (1999) (statement of Bill Saum, Director of the Agent and Gambling Activities Division of the National Collegiate Athletic Association) (stressing gambling on college campuses spreads throughout entire student bodies and "research reveals

As a result of these varied state concerns, at least ten states have attempted to outlaw Internet gambling.³⁹ Such initiatives have not, however, staved off cries that the federal government must act quickly to help the states in their goal of stopping Internet gambling in its tracks.⁴⁰ To do so, Congress would have to go against the grain of generally deferring to the lead of the individual states in formulating gambling policy, while at the same time acting within its Commerce Clause power. This power is precisely what the Senate relied on when it passed the IGPA.⁴¹ To understand the IGPA, however, it is also necessary to understand how it works in conjunction with the Interstate Wire Act, as the IGPA was originally a proposed amendment to that Act.⁴²

that the rates of pathological and problem gambling among college students are higher than any other segment of the population").

³⁹ Brown, *supra* note 5, at 15. Several state attorney general opinions have also addressed the legality of Internet gambling. Harley J. Goldstein, *On-Line Gambling: Down to the Wire?*, 8 MARQ. SPORTS L.J. 1, 32 (1997). For example, Robert A. Butterworth, Florida's Attorney General, in 1995 opined that Internet wagering taking place wholly within Florida would be prohibited by state law, and that the Interstate Wire Act would apply to persons outside of Florida (primarily bookmakers) transmitting wagering information into Florida. *Id.* at 40. Butterworth further observed that regulation of Internet gambling presents "a daunting challenge given the amorphous nature of cyberspace, with its lack of borders and its culture of anonymity." *Id.* at 41. Because of the exorbitant costs associated with the recording of the Internet addresses of gamblers at prohibited sites, as well as the fact that host computers are often located outside of the charging jurisdiction, Butterworth noted that "any effort to regulate use of the Internet is better suited to federal regulation than to patchwork attention by the individual states." *Id.* at 41-42.

⁴⁰ Kish, *supra* note 4, at 465. The 1996 National Association of Attorneys General (NAAG) Report recommended amending the Wire Act to specifically cover Internet gambling, and the enactment of state laws to allow for civil penalties for the violation of state gambling laws. Nicholas W. Allard & David A. Kass, *Law and Order in Cyberspace: Washington Report*, 19 HASTINGS COMM. & ENT. L.J. 563, 611 (1997). The NAAG Report further concluded that "most states have enacted a series of laws that either prohibit gambling, or allow some gambling in a delicately balanced legislative scheme. Internet gambling threatens this balance." *Id.*; see also Tratos, *supra* note 3, at 104 (arguing existence of state prohibitions on Internet gambling justifies need for Congressional action).

⁴¹ Kish, *supra* note 4, at 457.

⁴² *Id.* at 455.

B. The Interstate Wire Act and Its Limited Scope

In the beginning, the Interstate Wire Act (the "Wire Act"), originally passed in 1961, in no way contemplated a communication medium as technologically advanced as the Internet.⁴³ Codified at 18 U.S.C. § 1084, the Wire Act prohibits persons engaged in *the business* of betting and wagering from using wire communication outlets, in either interstate or foreign commerce, for such bets or wagers on any sporting event or contest.⁴⁴ Hence, though it clearly identifies sports wagering as a prohibited practice, the Wire Act is unclear as to whether other forms of gambling fall within its reach.⁴⁵ Furthermore, under the Wire Act, common carriers, when notified by a state or federal law enforcement agency that they are furnishing their communication outlet as a medium for transmitting or receiving gambling information in violation of any state or federal law, may be required to discontinue their services to any offending person or entity.⁴⁶

There are loopholes contained in the Wire Act. Primarily, gamblers themselves are excluded under the statute because they are not persons "engaged in the business of betting or wagering."⁴⁷ This is because the Wire Act was *not* designed to

⁴³ Fojut, *supra* note 1, at 161. Kevin Di Gregory, deputy assistant attorney general, testified before the House Judiciary Subcommittee on Crime that the Wire Act was passed "to assist the states and territories in enforcing their laws and to suppress organized crime involvement with gambling." Matthew E. Yarbrough, *Internet Gambling: The Risks and Rewards*, 547 PLL/PAT. 1213, 1218 (1999); *see also* Tratos, *supra* note 3, at 106 (arguing Wire Act is attempt "to empower those states which have determined that gaming should be illegal in their jurisdictions by prohibiting use of interstate communication to aid criminal activity").

⁴⁴ 18 U.S.C. § 1084(a) (1994). Specifically, the act provides that any person "engaged in the business of betting or wagering who knowingly uses a wire communication facility for the transmission . . . of bets or wagers or *information assisting in* the placing of bets or wagers on any sporting event or contest . . . shall be fined . . . or imprisoned not more than two years" *See id.* (emphasis added).

⁴⁵ Fojut, *supra* note 1, at 161.

⁴⁶ 18 U.S.C. § 1084(d) (2000). The common carrier must be subject to the jurisdiction of the Federal Communications Commission for this provision to apply. *See id.*

⁴⁷ *See id.* § 1084(a); *see also* Brown, *supra* note 5, at 21-22 (noting gamblers

protect gamblers from their own gambling proclivities.⁴⁸ Additionally, the statute makes an exemption for those bookmakers who place wagers on a contest to a location in another state if such wagering is legal in *both* states.⁴⁹ However, even if the gambling activity is legal in the state where it is received, if such activity was illegal in the jurisdiction in which the wager was placed, professional bookmakers may still be prosecuted.⁵⁰

Whether Internet gambling falls within the purview of the Wire Act is a live issue that has yet to be authoritatively adjudicated.⁵¹ Since Internet communications are transmitted

are not subject to liability individually under Wire Act); Yarbrough, *supra* note 43, at 1223 (including testimony of Kevin Di Gregory that, when Wire Act was passed, then-Attorney General Robert Kennedy felt Department of Justice had no intent to prosecute individual gamblers because of near impossibility of successfully undertaking such task).

A few courts have held, however, that a professional gambler may be subject to liability for a single use of an interstate facility in the pursuit of their gambling ventures. Tratos, *supra* note 3, at 106; *see also* United States v. Baborian, 528 F. Supp. 324, 328-29 (D.R.I. 1981) (noting Wire Act applies to individual gamblers only if they perform integral function of gambling enterprise, including being agent or employee of such operation, or share directly in such operation's profits and losses).

⁴⁸ United States v. Southard, 700 F.2d 1, 20 (1st Cir. 1983); *see also* S. REP. NO. 588 at 3 (1961) (noting that law enforcement authorities are "not interested in the casual dissemination of information . . . between acquaintances").

⁴⁹ 18 U.S.C. § 1084(b) (2000).

⁵⁰ Kailus, *supra* note 16, at 1060.

⁵¹ Brown, *supra* note 5, at 21. At least one commentator, however, has noted that attempts to apply current federal gambling statutes to Internet gambling "would be like performing brain surgery with stone tools." Keller, *supra* note 31, at 1596-97 (quoting I. Nelson Rose, *Wine Cops and the A.G.'s Take on Internet Gambling*, CASINO EXECUTIVE, Aug. 22, 1993, at 22).

A related case in this regard, though not dealing with the Wire Act, is United States v. Truesdale, 152 F.3d 443 (5th Cir. 1998). In *Truesdale*, the defendant World Sportsbook (WSB) set up bookmaking operations in the Dominican Republic and Jamaica (which were legal in each of those countries so long as the locals were not allowed to bet) that allowed American citizens to place sports bets by telephone without running afoul of American laws. *Id.* at 444. Offices with several employees were set up in each of these foreign jurisdictions, and there were toll-free numbers in both those countries, as well as in Dallas, Texas. *Id.* The lines which terminated in Dallas at two of WSB's corporate officer's homes "were 'information only' lines and were not used to accept bets." *Id.* To actively wager, a potential gambler had to wire money to WSB, which would then deposit the mon-

over phone lines, it would seem upon first impression that Internet gambling site operators would be covered by the statute.⁵² This may not be so simple a conclusion, however. The Wire Act only refers to "the placing of bets or wagers on any sporting event or contest."⁵³

ey in banks in the Dallas area. *Id.* at 444-45. The gambler would then have to call one of the foreign numbers to place a bet, and payouts would then be made from the Dallas accounts of WSB. *Truesdale*, 152 F.3d at 445. Law enforcement officials shut down WSB's operations in Dallas by searching the homes of the corporate officers. *Id.* A jury subsequently found the defendants guilty of violating 18 U.S.C. § 1955(a), which makes it illegal to conduct an illegal gambling operation, defined as one which "violates state or local law." *Id.* at 446. The law the defendants allegedly violated was a Texas statute prohibiting bookmaking in that state. *Id.* at 447.

The defendants argued that the bookmaking at issue occurred outside of the United States, and the Fifth Circuit agreed: "it is irrational to conclude beyond a reasonable doubt that after having gone through the effort of fully equipping, staffing, and widely advertising the Caribbean offices, the appellants nevertheless illegally accepted bets in the United States." *Id.* But see *United States v. Ross*, No. 98 CR. 1174-1, 1999 WL 782749, at *6-7 (S.D.N.Y. Sept. 16, 1999) (holding foreign bookmaking operation's receiving and processing of bets is "prosecutable offense" under Wire Act). The court stressed that the Texas statute was inapplicable to the facts presented because it only prohibited "recording, receiving, and forwarding bets; where and how the money [w]as paid out [wa]s irrelevant" *Truesdale*, 152 F.3d at 449.

Many virtual casino operators could similarly argue that they do not accept bets in the United States, and that their activities are lawful in the nations where the bets are received. Obviously enough, such an arrangement would pose a substantial impediment to actions brought against such operators under the Wire Act as far as the substantive commission of the crime is concerned, not to mention the myriad of difficulties associated with obtaining personal jurisdiction over virtual casinos and their corporate officers. See *infra* notes 126-36 and accompanying text.

⁵² See *infra* notes 126-36, and accompanying text; see also *Tratos*, *supra* note 3, at 107 (arguing Wire Act is applicable to Internet gambling because it uses telephone communication services). This rationale may eventually become obsolete if satellite technology makes it possible for gamblers to communicate with Internet gambling sites without the use of a phone line. *Id.* at 107 n.26.

⁵³ 18 U.S.C. § 1084(a) (2000); see also *Kailus*, *supra* note 16, at 1061 n.135 (pointing out that none of annotated cases under Wire Act apply to gambling unrelated to sports).

It is important to note that 21 owners and employees of Internet gambling operations were indicted for violating the Wire Act in the spring of 1999 "by the U.S. attorney's office in New York City. The cases marked the first federal prosecutions of sports betting over the Internet." Baker, *supra* note 5, at 54. Though the Justice Department, and Janet Reno in particular, have boasted that these

Kevin Di Gregory, Deputy Assistant Attorney General, testified before the Senate Subcommittee on Crime that the Department of Justice "recognizes that the advent of Internet gambling may have diminished the overall effectiveness of the . . . Wire Act . . . because that statute may relate only to sports betting and not to the type of real-time interactive gambling . . . the Internet makes possible for the first time."⁵⁴ As a result, Internet casinos that do not run sites with sports betting may not be subject to civil and/or criminal penalties under the Wire Act, at least as it currently exists.⁵⁵ On the other hand, it should be clear that the Wire Act does apply to bookmakers, if indeed the statute applies to the

prosecutions prove "[y]ou can't do online what you can't do in a store in Washington, D.C.," observers have strenuously argued that "the indictments, although a public relations coup for the Justice Department, will not go far in proving the Wire Communications Act is applicable to the various forms of Internet gambling." *Id.* at 54-57.

⁵⁴ Yarbrough, *supra* note 43, at 1219-20. Di Gregory also noted that the Department of Justice supports amending the Wire Act to make clear that it applies to both Internet sports and casino gambling, and that all Internet use is covered by the statute, even if transmitted with the use of satellite technology. *Id.* at 1220. A Justice Department spokesperson, John Russell, has dolefully observed: "International Internet Gambling? We can't do anything about it That's the bottom line." Steven Crist & Don Yeager, *All Bets Are off: The U.S. is on the Verge of an Explosion in Internet Sports Betting that could Change the Face of Gambling in this Country Forever. But is it Legal? And even if it isn't, can It be Stopped?*, SPORTS ILLUSTRATED, Jan. 26, 1998, available in 1998 WL 8979198. Further, traditional casinos generally support the IGPA, though "they are careful to rest their case on the regulatory argument, thus leaving their options open for the future." *Id.*

⁵⁵ Kailus, *supra* note 16, at 1061. It may be, however, that Internet casinos featuring only games of chance would be subject to the provisions of the Wire Act under a broad reading of that statute as, when the Wire Act was first passed in the early 1960s, wire transmissions were certainly not used to place bets on casino games. *Id.* The logical conclusion of this line of reasoning would be that the drafters of the Wire Act had no reason to place language in the statute about games of chance and that therefore such games should be read liberally into the statute in light of subsequent events. *Id.* Another important point with regard to Internet casinos is that such operations may pose greater potentials for fraud than Internet bookmaking because the results and the odds of sporting contests are individually and objectively verifiable by the gambler; with Internet casinos, there are no publicly available odds, and there is no way to independently verify the results of the spin of a roulette wheel. *Id.* at 1060 n.132.

Internet itself, because such persons are clearly involved in the business of wagering on sporting events.⁵⁶

It was with the objective of unequivocally clarifying these ambiguities that Senator Kyl introduced the Internet Gambling Prohibition Act in the Senate as an amendment to the Wire Act.⁵⁷

C. *The Proposed Internet Gambling Prohibition Act*

As originally proposed by Senator Kyl, the IGPA "would have clarified existing language of the Interstate Wire Act to insure that a law originally designed to stop organized crime's use of telephones for betting could now be used to prohibit gambling over a communication medium such as the Internet."⁵⁸ As the bill wound its way through Congress in the following months, its scope was greatly enlarged as, among many other notable additions, the language of the Wire Act was slated to include essentially all gambling contests, as opposed to just sporting events.⁵⁹ Eventually, a new Code

⁵⁶ *Id.* at 1059-60.

⁵⁷ Kish, *supra* note 4, at 455-56. *But see* Keller, *supra* note 31, at 1583-84 (arguing Wire Act's "literal language condemns all Internet transmissions to United States of digitized bits of information that create virtual gambling site on user's computer screen"; therefore, proposed IGPA is merely "superfluous").

⁵⁸ *Id.* at 455; *see also* Kailus, *supra* note 16, at 1066 (noting IGPA's original purpose "was to provide states the ability to restrict Internet gambling within their borders"); Goldstein, *supra* note 39, at 20 (explaining limited application of IGPA as originally proposed). In first proposing the amendment as an addition to the Crime Prevention Act of 1995, Senator Kyl explained that "[t]here is a new underworld of gambling evolving. Gambling on the Internet is on the rise That is why I have included a section which will make it illegal, if it is illegal to gamble in your state, to gamble on the Internet." Goldstein, *supra* note 39, at 20 & n.99.

⁵⁹ Internet Gambling Prohibition Act of 1999, S. 692, 106th Cong. (1999). Specifically, the Senate version of the IGPA defines "bets or wagers" as "the staking or risking by *any person* of something of value upon the outcome of a contest of others, *a sporting event, or a game of chance*, upon an agreement or understanding that the person or another person will receive something of value based on that outcome." *Id.* § 2 (emphasis added). The bill further defines a "person" in sweeping terms as "any individual, association, partnership, joint venture, corporation . . . or any other government, organization, or entity" *Id.*

On the other hand, the Senate version of the IGPA only imposes criminal

section was proposed to specifically address Internet gambling, as opposed to simply clarifying the Wire Act.⁶⁰

The bill passed the Senate on November 19, 1999, though it has yet to become law because the House of Representatives, which voted 245-149 in favor of the bill on July 17, 2000, failed to garner the two-thirds majority required for passage. Even so, the IGPA is quite broad and the specific aspects of its sweeping purview must be analyzed because of its potential passage in the near future.⁶¹

First, the Senate version of the IGPA allows either the federal government or the office of a state attorney general to commence proceedings against an alleged violator of the Act.⁶² Second, an Internet service provider may not be held

and civil penalties "on a person engaged in a gambling business." *Id.* (emphasis added). These penalties include the imposition of a civil fine "equal to not more than the greater of . . . the total amount that such person bet or wagered, or placed, received, or accepted in bets or wagers, . . . [or] \$20,000," as well as imprisonment for a term of up to four years, or both. *Id.* Thus, the version of the IGPA introduced by Senator Kyl in 1999 differs from its forebears in that it "does not attempt to criminalize the individual bettor, rather it focuses on the 'business' of Internet gambling." Karadbil, *supra* note 4, at 430 (citation omitted). One impetus for this change of strategy was that the Department of Justice "made it clear that it did not support a law that would require knocking on bedroom doors to go after \$5 bettors." Rose, *supra* note 10, at 235. As a result, it is not imprudent to argue that "[a]nyone who doubts that politics shapes legislation should examine the history of the [IGPA]." *Id.* at 234.

⁶⁰ Kish, *supra* note 4, at 455.

⁶¹ See, e.g., Crist & Yeager, *supra* note 54 (explaining there is already "a strange-bedfellows confederacy in opposition to Internet gambling, including the Christian Coalition, casino operators, the NCAA, the NFL, the NHL and Ralph Nader's Public Citizen watch"). Several House lawmakers have already called for a new vote on the IGPA. Further, the National Gambling Impact Study Commission (NGISC), created by Congress to examine and report on the impact of gambling in the United States, reported back to Congress and President Clinton in June of 1999 that the unchecked growth of Internet gambling requires the development of a strategy to prohibit it. Karadbil, *supra* note 4, at 445-46.

However, "[s]upporters of high-tech sports wagering, who number gamblers, bookmakers, Internet entrepreneurs and civil libertarians, are confident they will prevail." *Id.* An experienced Austrian bookmaker has observed that "[g]ambling is the future of the Internet You can only look at so many dirty pictures." *Id.*

⁶² Internet Gambling Prohibition Act, S. 2782 § 2, 106th Cong. (1999). The relief to which either prosecuting agency would be entitled includes the entering of a temporary restraining order or an injunction if a district "court determines,

liable so long as (1) the illegal subject matter was not initiated by the provider; (2) the providing of the Internet connection is done "without selection of the material or activity by the provider"; (3) the provider plays no part in selecting the recipient of the forbidden material "except as an automatic response to the request of another person"; and (4) the material is transmitted through the network without modification of its content by the provider.⁶³ However, if an Internet service provider receives notice from an appropriate federal or state law enforcement agency that its services are being used by "a particular online site" to violate the IGPA, it must "remove or disable access to the material or activity residing at that online site"⁶⁴

Detailed exceptions are also provided for: wholly intra-state wagers made on state lotteries if placed from a closed-circuit network; multi-state lotteries authorized and regulated by two or more states if placed from a closed-circuit; both dog and horse racing, assuming such wagering is legal in the place where both the gambler and the Internet casino are located; and "any otherwise lawful bet or wager that is placed, received, or otherwise made for a fantasy sports league game or contest."⁶⁵

As a result, "the IGPA prohibits states from choosing to permit Internet gambling within their own borders and prevents gambling transmissions from occurring between two

after providing written notice and an opportunity for a hearing, that there is a substantial probability that such violation has occurred or *will occur*." *See id.* (emphasis added). Likewise, a professional or amateur sports association whose participating athletes are alleged to be violators of the IGPA may commence a civil action in a federal district court to restrain such a violation, whereupon such association is entitled to the same relief as would be the federal government or a state attorney general. *See id.*

⁶³ *See id.*

⁶⁴ *See id.*

⁶⁵ *See id.*; see also Tom Lundin, Jr., Comment, *The Internet Gambling Prohibition Act of 1999: Congress Stacks the Deck Against Online Wagering but Deals in Traditional Gaming Industry High Rollers*, 16 GA. ST. U. L. REV. 845, 877 (2000) (arguing "[i]f Congress' primary concern is truly the social costs of Internet gambling, it makes little sense for it to create a loophole for horse-racing bet from a private computer.").

states that have legalized phone betting.”⁶⁶ Because of the sweeping nature of the IGPA, and considering that it specifically targets gambling through the use of one communication medium for total prohibition, there are bound to be both legal and policy challenges to the potential passage of the IGPA.⁶⁷

IV. LEGAL AND POLICY CONCERNS RAISED BY THE LIKELY PASSAGE OF THE INTERNET GAMBLING PROHIBITION ACT

A. *Disturbance of Traditional Federal-State Relations and Commerce Clause Concerns*

As noted above, gambling regulation in the United States has traditionally been viewed as a state concern rather than a federal one.⁶⁸ Accordingly, the possible passage of the IGPA, with its outright ban on Internet gambling, would clearly upset this balance because the individual states would not be free to make their own choices regarding either the legality or regulation of this mode of gambling.⁶⁹ Pursuant to the Supremacy Clause of the United States Constitution, any state law conflicting with the IGPA would be rendered invalid.⁷⁰

⁶⁶ Kish, *supra* note 4, at 456.

⁶⁷ *Id.* at 451. Senator Kyl has himself observed that “[t]here are those who say we should just regulate Internet gambling I don’t believe it can be regulated, so we have to prohibit it.” Crist & Yeager, *supra* note 54. On the other hand, Sue Schneider, the Chairman of the Interactive Gaming Council, a coalition of Internet gambling site operators, has asked: “How arrogant is it for American politicians to say that those nations [already regulating Internet gaming] aren’t good enough to regulate this industry?” *Id.*

⁶⁸ See *supra* notes 18, 19 and accompanying text. In line with this general deference in favor of the states, the 1976 Commission on the Review of the National Policy Toward Gambling recommended that the individual states should be free to determine the legality of various gambling activities within their borders so as to capture the political will of their constituents. Kish, *supra* note 4, at 450.

⁶⁹ See Kish, *supra* note 4, at 456-57.

⁷⁰ Kristen D. Adams, Comment, *Interstate Gambling—Can States Stop the Run for the Border?*, 44 EMORY L.J. 1025, 1037 (1995). Specifically, the Supremacy Clause provides that “[t]his Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the Supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the

Clearly, gambling in general is an activity that can have interstate effects in addition to intrastate ones.⁷¹ Even so, traditional gambling establishments (e.g., racetracks, bingo parlors, and casinos) can usually be contained and regulated by a given state while having minimal effects on another state's citizens.⁷² Gambling may, however, take on a decidedly different nature when combined with the use of mass communication technology, including telephones, televisions, and now the Internet.⁷³ When gambling in one state will "substantially affect the economic affairs of another state, perhaps one that chooses to prohibit gambling entirely," the federal government may regulate or even prohibit that activity pursuant to the Commerce Clause of the United States Constitution.⁷⁴ Congress relied on this very power when it passed the IGPA.⁷⁵

The Internet, by its very nature, can have substantial effects on interstate and even international commerce, as any American user can almost instantaneously communicate with another person on the other side of the world, perhaps to place a wager.⁷⁶ Because of this unique facet of Internet communi-

Constitution or Laws of any State to the Contrary notwithstanding." U.S. CONST. art. VI, cl. 2.

⁷¹ See Kish, *supra* note 4, at 457.

⁷² *Id.* This might not always be the case; for instance, a casino or racetrack located in an extreme corner of one state might draw a majority of its customers from neighboring states.

⁷³ See *id.*

⁷⁴ *Id.*; see also *supra* note 19 and accompanying text. The Commerce Clause grants to the United States Congress the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. CONST. art. I, § 8, cl. 3.

⁷⁵ Kish, *supra* note 4, at 457. Congress has also relied on this power to regulate gambling related activities in the past, including, among other statutes, the Interstate Wire Act, the Professional and Amateur Sports Protection Act, the Travel Act, and the Racketeer Influenced and Corrupt Organizations Act. Brown, *supra* note 5, at 21.

⁷⁶ See *supra* notes 5, 24 and accompanying text. Perhaps "[n]o single technological advancement has been able to unite people and ideas so efficiently The Internet . . . has had a profound impact on global commerce, far exceeding its initial dedication to military and scientific applications." Hogan, *supra* note 22, at 818-19. The Internet "knows no boundaries . . . [and] is accessed by folks in

cation, it might appear at first glance that the passage of the IGPA would be a "flawless congressional application of the Commerce Clause."⁷⁷ However, the Supreme Court has been less willing in recent years to blindly acquiesce to congressional judgment regarding what actions affect interstate commerce, and are therefore subject to congressional regulation.⁷⁸ Specifically, a perfunctory examination of the Commerce Clause and the letter and rationale of the IGPA fails to take into account the highly relevant case of *United States v. Lopez*.⁷⁹

In *Lopez*, the appellant-defendant was convicted of the possession of a firearm in a school zone in violation of the Gun-Free School Zones Act.⁸⁰ Because "[t]he Act neither regulated a commercial activity nor contain[ed] a requirement that the possession be connected in any way to interstate commerce," the Supreme Court held that the Act was constitutionally infirm in that its passage constituted an overstepping by Congress of its Commerce Clause powers.⁸¹ After going through an explanation of the history of its Commerce Clause jurisprudence, the Court pointed out that, beginning in the late 1930s, its decisions greatly expanded the scope of Congress' powers under the Commerce Clause, primarily reflecting "a view that earlier Commerce Clause cases artificially had constrained the authority of Congress to regulate interstate commerce."⁸²

rural and urban areas alike, in large countries as well as small [Additionally, t]he array of Internet information is endless. Available Internet content seems to be limited only by one's imagination." Fojut, *supra* note 1, at 157-58. For a thorough technical discussion of how the Internet operates and whether it can truly ever be regulated in a traditional sense, see Goldstein, *supra* note 39, at 4-18.

⁷⁷ Kish, *supra* note 4, at 457.

⁷⁸ See *id.* at 457.

⁷⁹ 514 U.S. 549 (1995).

⁸⁰ *Lopez*, 514 U.S. at 551.

⁸¹ *Id.* The Fifth Circuit Court of Appeals had reached the same conclusion on the basis of Congress' meager findings. *Id.* at 552.

⁸² *Id.* at 553-56. The Court noted that its cases during the meantime had declared that "[w]hether particular operations affect interstate commerce sufficiently to come under the constitutional power of Congress to regulate them is ultimately

Accordingly, the Court held its jurisprudence has identified three specific areas where Congress is free to regulate interstate commerce: (1) "the use of the channels of interstate commerce," (2) the instrumentalities of interstate commerce (including "persons or things in interstate commerce"); and (3) those activities which have a "substantial relation to interstate commerce."⁸³ As to the last category, the Court stressed that, notwithstanding ambiguities in its previous case law, the test for such an assertion of congressional power should be "whether the regulated activity '*substantially affects*' interstate commerce."⁸⁴ The Court noted the Act was clearly not an attempt to regulate the use of a channel of interstate commerce, and that it also was not an attempt to regulate an instrumentality or thing in interstate commerce.⁸⁵ Hence, if the Act was to be constitutional, it had to "substantially affect" interstate commerce.⁸⁶

As to this inquiry, the Court held the Gun Free-School Zones Act has nothing to do with "'commerce' or any sort of economic enterprise, however broadly one might define those terms."⁸⁷ The Court took notice of the fact that the Act failed to contain any jurisdictional hook that would require that banned firearms affect interstate commerce in any way.⁸⁸ The Court also found distasteful the government's assertion that it

a judicial rather than a legislative question, and can be settled finally only by this Court." *Id.* at 557 n.2. (quoting *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241, 273 (1964) (Black, J., concurring)); see also *Maryland v. Wirtz*, 392 U.S. 183, 197 n.27 (1968) (stressing that "where a general regulatory [scheme] bears a substantial relation to commerce," it is of no consequence that *individual instance* arising under such scheme has minimal effects on interstate commerce) (overruled by *National League of Cities v. Usery*, 426 U.S. 833, 854-55 (1976)).

⁸³ *Lopez*, 514 U.S. at 558-59.

⁸⁴ *Id.* at 559 (emphasis added).

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* at 561. The Court also held that the Act was not part of a larger economic regulatory scheme that would be seriously undermined were it not allowed to include intrastate activities within its scope. *Id.* As a result, the Court determined that the Act, to pass constitutional muster, would have to, in the aggregate, substantially affect interstate commerce. *Id.*

⁸⁸ *Lopez*, 514 U.S. at 561.

should acquiesce to congressional wisdom without explicit findings on the effect of the Act on interstate commerce: "to the extent that congressional findings would *enable us to evaluate* the legislative judgment that the activity in question substantially affected interstate commerce, . . . they are lacking here."⁸⁹

Even so, the government argued that the possession of guns in school zones substantially affected interstate commerce in that violent crime creates substantial costs (e.g., insurance); that the presence of guns near schools would discourage persons from traveling or moving to supposedly unsafe states; and that the presence of guns in school vicinities would cripple the overall learning process, with concomitant adverse affects on the nation's economy.⁹⁰ The Court dismissed out of hand the "national productivity" argument, in that such a policy could allow Congress to regulate virtually any activity that it found to be related to the country's economic well-being.⁹¹ As to the government's first two arguments, the Court held the possession of a gun in a school zone, even through widespread repetition, is not an activity that substantially affects interstate commerce.⁹² Finally, the Court added that for it to hold otherwise would be to obliterate the "distinction between what is truly national and what is truly local."⁹³

Applying this mode of analysis to the IGPA, it may be that Congress would overstep its Commerce Clause powers in

⁸⁹ *Id.* at 563 (emphasis added).

⁹⁰ *Id.* at 563-64.

⁹¹ *Id.* at 564. The Court cited potential widespread congressional intrusion into the realms of domestic law, criminal law enforcement, and education, all strong traditional state concerns, as some of the specters it was concerned with. *Id.* Were it to uphold the Act on this principle, the Court felt it would be "hard pressed to posit any activity by an individual that Congress . . . [would be] without power to regulate." *Id.*

⁹² *Id.* at 567. On this point, the Court noted that "Respondent was a local student at a local school; there is no indication that he had recently moved in interstate commerce; and there is no requirement that his possession of a firearm have any concrete tie to interstate commerce." *Id.*

⁹³ *Id.* at 567-68.

its zealous efforts to completely ban Internet gambling should the IGPA become law. Primarily, any arguments by the government that the Internet would create a "substantial negative economic impact" must be tempered with the knowledge that many states already allow the *types* of gambling currently being offered over the Internet; therefore, how could Internet gambling *alone* have a substantial effect on interstate commerce if the underlying activity, as long as it takes place through other mediums, is legal?⁹⁴

As *Lopez* made clear, the Supreme Court is unwilling blindly to defer to congressional judgment about matters which substantially affect interstate commerce; the Court will undertake its own independent inquiry of this issue, and congressional findings are an added plus.⁹⁵ Additionally, the Court in *Lopez* seemed more than a little concerned with federal intrusions into substantive areas of law that have traditionally been subject to state regulation.⁹⁶ As noted previous-

⁹⁴ See Kish, *supra* note 4, at 458. This rationale should still prevail in the face of arguments that Internet gambling is particularly prone to causing addiction and presenting widespread opportunities for consumer fraud because these concerns are also present with virtually any type of gambling imaginable, and it would be hard to sustain the proposition that these concerns are so unique to Internet gambling that they constitute a substantial effect on interstate commerce.

Also particularly noteworthy is the fact that the most strident supporters of the IGPA are often legislators from states with pro-gambling policies. Kailus, *supra* note 16, at 1069. It might then be argued by opponents of the IGPA that "[u]nder the guise of protecting the public, the underlying motivation behind state gambling regulation is financial control by interest groups and generation of tax revenue. The moral justifications of gambling regulation easily become malleable in an attempt to adjust to economic reality." *Id.* at 1070. However, even if the "states have shifted from a position of moral-based legislation to a posture of self-serving regulation," that should be irrelevant, in and of itself, to a discussion of the constitutionality of the IGPA. *Id.* Whether Congress has acted to prohibit or regulate an activity that substantially affects interstate commerce is another issue from *why* Congress has acted with regard to such an activity.

⁹⁵ See *supra* note 89 and accompanying text.

⁹⁶ See *supra* notes 91, 92 and accompanying text; see also *Greater New Orleans Broad. Ass'n v. United States*, 119 S. Ct. 1923, 1935 n.8 (1999) (explaining that meaning of *Edge* was that Congress should balance interests of lottery versus those of non-lottery states, rather than merely advance interests of latter); *United States v. Edge Broad. Co.*, 509 U.S. 418, 426 (1993) (holding that supporting anti-gambling policies of non-lottery states, as well as not interfering with

ly, gambling regulation is one such area.⁹⁷ A related concern is that the IGPA does not even permit *intrastate* gambling via the Internet.⁹⁸ The IGPA clearly forecloses this possibility, with the exceptions of intrastate wagers made on state lotteries and legalized dog and horse racing.⁹⁹

Accordingly, Congress may have failed to take into account the various hurdles the IGPA will have to jump through to pass constitutional muster. The IGPA fails to contain any jurisdictional hook (e.g., such that a wager must pass from one state to another where such wagering is illegal, or vice versa)¹⁰⁰ and seems to target one communication medium for outright prohibition even though many other forms of gambling are allowed (and even encouraged) by Congress.¹⁰¹ As a result, Commerce Clause questions are likely not the only ones that will arise with respect to the potential passage of the IGPA.

B. First Amendment Concerns Implicated by the IGPA

As a general rule, First Amendment challenges to Congress' power to regulate gambling based on its status as a "vice" activity have met with very little success.¹⁰² It was

policies of those states that do, is substantial government interest for commercial speech purposes).

⁹⁷ See *supra* notes 18, 19 and accompanying text.

⁹⁸ Kish, *supra* note 4, at 458. Federal gaming regulation in the past has usually included exemptions for those states that legalize the particular activity. *Id.* The Wire Act provides such an exception, provided the wager is legal in both the state where the bet is placed and the place where the bet is received. See *supra* note 49 and accompanying text.

⁹⁹ See *supra* notes 65, 66 and accompanying text. As to such exceptions, Tom W. Bell, the Cato Institute's director of technology studies, has strenuously argued that "this is not a moral issue, this is an issue about who has more lobbying clout." Kailus, *supra* note 16, at 1070.

¹⁰⁰ See *supra* note 88 and accompanying text.

¹⁰¹ See, e.g., *Greater New Orleans*, 119 S. Ct. at 1931 (explaining congressional policy has reflected "a decision to defer to, an even promote, differing gambling policies in different States.").

¹⁰² Kish, *supra* note 4, at 459. This has left both state and local governments free to regulate gambling with little concern that their legislation will be found

"[w]ith this constitutional history of gambling's inferior status in mind . . . [that] the Senate passed the IGPA believing that restricting gambling over the Internet was equivalent to restricting any other type of traditional gambling activity and, therefore, would not implicate any First Amendment concerns."¹⁰³ As with the prior Commerce Clause analysis, it may be that the Senate overlooked a highly relevant Supreme Court pronouncement concerning the Internet and the First Amendment: *Reno v. American Civil Liberties Union*.¹⁰⁴

In *Reno*, the Supreme Court struck down the Communications Decency Act (CDA), which criminalized the "knowing" transmission of 'obscene or indecent' messages [over the Internet] to any recipient under 18 years of age."¹⁰⁵ The Court, after a brief discussion of the internal technology of the Internet, observed that the "odds are slim" that a user, including a minor, would accidentally encounter a sexually explicit site.¹⁰⁶ The Court explained that the CDA differed from previous legislation upheld by the Court in that the CDA failed to allow for parents who might wish their children to view such

unconstitutional. *Id.* at 459-60.

¹⁰³ *Id.* at 460.

¹⁰⁴ 521 U.S. 844 (1997).

¹⁰⁵ *Reno*, 521 U.S. at 844. The challenged CDA provisions allowed for both civil and criminal penalties. *Id.* at 859. Exemptions were contained in the statute for "good faith" and "effective" actions to restrict access to minors. *Id.* at 844. As to the mode of transmission of such targeted messages, the Court initially noted that sexually explicit material is created and accessed the same as any other website, and may be accessed intentionally or in the process of running a general search. *Id.* at 853.

¹⁰⁶ *Id.* at 854. Additionally, Internet communications do not "invade" a person's home as do other broadcasts. *Id.* at 869. The Court explained the Internet differs fundamentally from radio and television messages in that the Internet, by its very nature, requires affirmative steps to receive the desired information; specifically, "[a] child requires some sophistication and some ability to read and retrieve material and thereby to use the Internet unattended." *Id.* at 854. The Court explained logging on to an offending site to placing a telephone call requires affirmative, conscious steps toward the end of accessing the subject material are required. *Id.* at 869-70. The Court further determined that age verification systems are prohibitively expensive for noncommercial sites, and such a requirement would cripple the operation of many Internet content providers. *Reno*, 521 U.S. at 856-57.

material to do so under any circumstances, and the CDA failed to define "indecent."¹⁰⁷

The Court noted that the CDA provisions at issue were not limited to any particular time frame children are particularly likely to be accessing the prohibited material, and that there was no agency with special knowledge and expertise of the Internet's unique characteristics charged with enforcement of the statute.¹⁰⁸ Further, the Court found instructive the fact the Internet has no history of limited First Amendment protections: "Neither before nor after the enactment of the CDA have *the vast democratic forums* [sic] of the Internet been subject to the type of government supervision and regulation that has attended the broadcast industry."¹⁰⁹ In sum, the Court held because "the CDA applies broadly to the entire universe of cyberspace [a]nd the purpose of the CDA is to protect children from the primary effects of 'indecent' and 'patently offensive' speech, . . . the CDA is a *content-based blanket restriction on speech*."¹¹⁰

The Court determined the CDA was not narrowly tailored toward meeting Congress' goal of protecting minors from harmful materials because of the significant chilling effect the CDA could have on speakers who are unsure what "indecent" really means.¹¹¹ Accordingly, the Court held the CDA was facially overbroad in that its ambiguities "could be avoided by a more carefully drafted statute."¹¹² Therefore, just because Congress had a strong interest in protecting children, it was not justified in reducing the entire population to only that

¹⁰⁷ *Id.* at 865. Especially troublesome in the Court's estimation was that there was no requirement that the offending material "lack serious literary, artistic, political, or scientific value." *Id.* at 865. The Court speculated that a parent who simply sent his college freshman detailed information on birth control via e-mail might be subject to criminal penalties under the CDA. *Id.* at 878.

¹⁰⁸ *Id.* at 867.

¹⁰⁹ *Id.* at 868-69 (emphasis added).

¹¹⁰ *Reno*, 521 U.S. at 868 (emphasis added).

¹¹¹ *Id.* at 871.

¹¹² *Id.* at 874. Important in this regard is the fact that sexual expression which is "indecent" but not obscene receives First Amendment protection, even though the latter does not. *Id.*

which is fit for children's eyes.¹¹³

Reno's broad-based analysis of Internet regulation and the protection of children from harmful subjects or materials is instructive with regard to the IGPA.¹¹⁴ Primarily, as one of the main justifications for the passage of the IGPA is the protection of minors, the Government could find the IGPA falling to the same fate as the CDA.¹¹⁵ In its zeal to ban Internet gambling entirely, it may be that Congress has indeed tried to limit the entire American populace to only that which is fit for the eyes of children.¹¹⁶

Further, unlike the viewing of indecent or obscene materials on the Internet, it is clear Internet gambling websites have "a built-in method for insuring that its Web sites are only accessed by individuals over the age of eighteen—the credit card."¹¹⁷ The IGPA may also fall prey to the vagueness con-

¹¹³ *Id.* at 875. The Court found especially distasteful the fact there were no Congressional findings regarding the "special problems of the CDA." *Id.* at 879. Ultimately, the Court narrowed the statute by striking the term "indecent" from the challenged provisions, while allowing the phrase "obscene" to stand. *Id.* at 883.

¹¹⁴ See Kish, *supra* note 4, at 460.

¹¹⁵ *Id.*; see *supra* note 38 and accompanying text.

¹¹⁶ See *supra* note 113 and accompanying text; see also 146 CONG. REC. E 1269-02 (daily ed. July 17, 2000) (statement of Rep. Paul) (arguing IGPA's intrusion into Internet expression will have "unintended consequences This principle could be argued in favor of restrictions on freedom of expression and association. Disapprove of gambling? Let the government step in and ban it on the Internet! Minority rights are obviously threaten by majority whims."). But cf. 146 CONG. REC. E 1304-02 (daily ed. July 24, 2000) (statement of Rep. Jackson-Lee) (arguing in favor of IGPA's passage, but explaining the government must "toe the line when [enforcing] this measure. We do not want to trample upon the privacy rights of individuals.").

¹¹⁷ Kish, *supra* note 4, at 460-61; see also *supra* note 11 and accompanying text. As a result, if children wish to gamble on the Internet, they are forced to appropriate either their parents' credit cards or steal them from other persons. Kailus, *supra* note 16, at 1072. Minors "inclined to such theft have countless other Internet, telephone, and mail-order services at their fingertips, but this is not a valid reason to prohibit all Internet, telephone, and mail-order commerce." *Id.* Likewise, the minor's parents would certainly know of the child's gambling proclivities "long before the child became a candidate for Gambler's Anonymous." Kish, *supra*, at 461. Certainly, a gambling website owner has little incentive to peddle his wares to children since he must fear that the parents of the child will call their credit card company and have the account or line of payment to the

cerns that troubled the Court with the CDA in *Reno*.¹¹⁸ For example, the IGPA prohibits "information" which assists in the placing of bets or wagers; under this vague standard, simply posting the odds on a game, with nothing more, might subject one to criminal and civil liability for such a seemingly mundane activity.¹¹⁹ Clearly, this would constitute the same chilling effect on protected speech that so bothered the Court in *Reno*.¹²⁰ Additionally, the Court in *Reno* noted that the Internet is not now, nor has it ever been, subject to the broad content restrictions that normally attend television and radio broadcasts.¹²¹

Therefore, the potential passage of the IGPA by both houses of Congress seems just as open to constitutional attack on First Amendment grounds as it does on Commerce Clause

website canceled.

¹¹⁸ Kish, *supra* note 4, at 461-62; *see also supra* notes 108, 112-14 and accompanying text.

¹¹⁹ *See* Kish, *supra* note 4, at 462. All one has to do is look in the sports section of basically any major newspaper for the odds on the major professional and college sports games for a given week; it would certainly seem an anomaly that the government never even raises an eyebrow about these postings, yet would potentially be willing to subject an individual who posts such odds on the Internet to civil and even criminal liability for doing the exact same thing. Indeed, the IGPA makes an explicit exception for "any news reporting or analysis of wagering activity." Internet Gambling Prohibition Act, S. 692 § 2(a)(5)(B)(iv), 106th Cong. (1999).

¹²⁰ *Id.*; *see also supra* notes 110, 117 and accompanying text. It seems clear that by utilizing the term "information" which assists in the placing of bets or wagers, the Senate has attempted to regulate the content of the Internet, and should therefore be subject to the strict level of scrutiny utilized by the Court in *Reno*. *See* Kish, *supra* note 4, at 462; *supra* note 110 and accompanying text.

¹²¹ *See supra* note 109 and accompanying text. In addition, the Court has been less willing in recent years to uphold blanket bans on gambling advertising, as *Greater New Orleans* attests. *See supra* note 96 and accompanying text. While the issue here is not advertising, this trend may show that the Court is less willing today to totally defer to Congressional targeting, in general, of traditional vice activities. It may also be argued that Internet websites for traditional casinos that do not allow betting over the Internet, but simply advertise their business' wares, could be subject to liability under the IGPA because of the vagueness of the phrase "information assisting in the placing of a bet or wager" which is nebulously defined as "information that is intended by the sender or recipient to be used by a person engaged in the business of betting or wagering to place, receive, or otherwise make a bet or wager." S. 692, 106th Cong. § 2(a)(5)(A) (1999).

principles.

*C. Enforcement Problems Associated with
the IGPA*

The foregoing subsections have focused on the legality of Congress' proposed prohibition of Internet gambling. These issues are concerned necessarily with whether Congress has the Constitutional *power* to enact such a prohibition. I turn now to the altogether different issue of whether Congress *should* pass such a law in light of the perplexing enforcement problems that would likely be associated with it.

Given the fact that many of the Internet casinos which would fall within the statute's prohibition are located abroad, the most obvious concern with the enforcement of the IGPA is whether or not such casinos can be effectively prosecuted in American courts.¹²² After all, these site operators are usually located abroad for the very *purpose of avoiding* congressional regulation.¹²³ As a result, "the procurement and enforcement of extraterritorial jurisdiction presents the single greatest challenge to the regulation of Internet gambling. . . . The widely differing and often conflicting approaches . . . taken by foreign countries creates for U.S. regulators a jurisdictional problem of truly global proportion."¹²⁴

Specifically, for a United States court to exercise extraterritorial jurisdiction over a defendant, that court must have subject matter jurisdiction over the controversy at issue, as

¹²² See Kailus, *supra* note 16, at 1073-74 n.235 (noting Senator Kyl's deputy press secretary has himself admitted IGPA would likely have little effect on off-shore Internet casino operators).

¹²³ Fojut, *supra* note 1, at 169. Conversely, it is unlikely that well-known, traditional casinos that are already highly regulated (e.g., Caesar's Palace) will jump in wholeheartedly for a share of the Internet gambling market and thereby "risk the real profits these casinos make daily in order to capture digital dollars that are uncertain at best." Tratos, *supra* note 3, at 116. If, however, such a well-known casino were to go on-line, consumer confidence and the likelihood of fair payouts would likely be substantially increased. *Id.*

¹²⁴ Brown, *supra* note 5, at 30. Apparently such controversies have been around since the establishment of the first multinational corporations. *Id.* at 30-31.

well as personal jurisdiction over the defendant.¹²⁵ Because the IGPA applies extraterritorially by its own terms,¹²⁶ the personal jurisdiction inquiry would be the most troublesome enforcement aspect of the IGPA should it become law.¹²⁷ An important concern regarding the fairness of exerting personal jurisdiction over a foreign Internet site operator involves whether such an operator could, "without suspecting it, be subject to prosecution in any jurisdiction from which the site could be accessed, raising the specter of potential jurisdiction worldwide."¹²⁸

¹²⁵ *Id.* at 31.

¹²⁶ See S. 692, 106th Cong. § 2 (1999). In the last three decades, congressional attempts to increase the presence of the United States abroad have met with limited success. Seth Gorman & Anthony Loo, Comment, *Blackjack or Bust: Can U.S. Law Stop Internet Gambling?*, 16 LOY. L.A. ENT. L.J. 667, 690 (1996). Specifically, Congress' attempts to counter drug trafficking, money laundering, and terrorism have been countered by laws passed in other countries which have been aimed directly at the United States, particularly bank secrecy laws. *Id.* These "resulting clashes and retaliatory measures are the reasons why the United States has historically avoided interfering with the acts of foreign nations." *Id.*

¹²⁷ Fojut, *supra* note 1, at 169. Clearly, however, American courts would have personal jurisdiction over a defendant corporation if it were incorporated in the United States, or if any of the owners were American citizens or could be arrested in the United States. *Id.*

¹²⁸ Keller, *supra* note 31, at 1597. Courts confronted with similar issues have apparently asked two questions: (1) whether the in-state effects caused by the defendant's activity with the forum state should have been sufficiently foreseeable to the defendant for it to be forced to defend in an action there, and (2) whether an assertion of jurisdiction denies a defendant due process of law. *Id.* In particular, courts have developed a sliding scale test to determine whether such an assertion of personal jurisdiction passes constitutional muster. *Id.* At one extreme, courts by and large do not allow personal jurisdiction when the website involved passively provides information to its users. *Id.*; see also *Bensusan Restaurant Corp. v. King*, 937 F. Supp. 295, 301 (S.D.N.Y. 1996) (finding that assertion of personal jurisdiction would violate due process because mere general information on night club was not purposeful availment of benefits of forum state), *aff'd*, 126 F.3d 25, 29 (2d Cir. 1997). At the other extreme, courts usually have little difficulty in asserting jurisdiction over those websites that fully interact with their users and actively conduct business on-line. Keller, *supra* note 31, at 1598.

An illustrative case in this regard is *Thompson v. Handa-Lopez, Inc.*, 998 F. Supp. 738 (W.D. Tex. 1998). In *Thompson*, a Texas resident commenced suit against a California gambling website to recover his substantial winnings. *Id.* at 741. The court began by referencing the sliding scale, as well as the familiar due process requirements that, for a defendant to be subject to personal jurisdiction,

The most likely scenarios for obtaining personal jurisdiction over an offending website operator would be: (1) to have the host country arrest the defendant and turn him over to United States authorities pursuant to an existing extradition treaty, or (2) to rely on the good graces of another country that would be willing to turn an offender over to American authorities under the doctrine of international comity.¹²⁹ Especially with regard to the latter possibility, it is highly unlikely that any foreign country which legalizes Internet gambling, and even promotes it, would ever willingly turn over a potential defendant to the United States for prosecution under American domestic laws.¹³⁰ The attempted enforcement of the IGPA against foreign website operators would "force the U.S. government into an awkward international position where it criticizes countries that try to subject [American] Web site operators to their indecency laws while simultaneously de-

he must have minimum contacts such that he could "reasonably anticipate being haled into court there," *Id.* at 743 (quoting *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980)), and the assertion of jurisdiction must not "offend traditional notions of 'fair play and substantial justice.'" *Id.* (quoting *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)). The defendant argued neither of these requirements was met because it had no offices in Texas, and its server and place of business were both located in California. *Id.* The Court disagreed, based on: (1) the defendant's holding itself out as the "World's Largest" Internet Casino; (2) the continuous exchange of information and entering into contracts with Texans; (3) the fact that winnings were sent from California to Texas; and (4) the immateriality of the defendant not specifically directing its wares at Texas, because the Internet was designed "to communicate with people in every state." *Id.* at 743-44.

It is important to remember that, in some ways, the foregoing analysis simply begs the question regarding personal jurisdiction. The defendant in *Thompson* was a California website, not a foreign one (in an international sense), and the bringing of the latter group to trial will, almost invariably, depend on the good graces of the country in which the gambling website is itself based. See Fojut, *supra* note 1, at 169-71. Hence, "[a]s problematic as jurisdictional issues among the several states are, they are exponentially more so in the international arena." Brown, *supra* note 5, at 30.

¹²⁹ Fojut, *supra* note 1, at 170. "Comity" is loosely defined as "a discretionary doctrine based on notions of passive consent and inconvenience, which would lead the courts of one country to give effect to legal acts done in another country." *Id.* (citation omitted). It is essentially based on international etiquette and good will, rather than any binding legal obligation. *Id.*

¹³⁰ *Id.*

manding all foreigners adhere to the gambling laws of the United States."¹³¹

Deference to a foreign country's domestic laws is necessary in many cases to stave off the potential destabilization of international legal, economic, and diplomatic relations.¹³² Critics have already charged that seeking to apply American laws to gambling website operators located in countries where they are duly licensed "would violate the sovereignty of those host countries and smack of colonialism."¹³³ As to extradition, it is usually provided for only if the activity at issue is a crime in both nations, which is clearly not the case with a great number of gambling websites.¹³⁴ Furthermore, there are currently no international agreements pertaining to any aspect of Internet regulation.¹³⁵

Another important concern relates to how individual gambling sessions would be detected by law enforcement agencies.¹³⁶ Currently, gamblers may hide their identities by either disguising their source or using a false name.¹³⁷ While such scheming is not foolproof, it can be both expensive and time-consuming to detect.¹³⁸ Passage of the IGPA would likely cause gambling website operators to use advanced encryption technologies, particularly in lieu of credit card numbers and their resulting paper trails, to protect themselves and their users from detection.¹³⁹

¹³¹ Kish, *supra* note 4, at 463.

¹³² See Gorman & Loo, *supra* note 126, at 689. Historically, the courts have refused to hear those cases which would seek to pass upon the validity or effect of another sovereign's laws. *Id.* at 688.

¹³³ Keller, *supra* note 31, at 1600.

¹³⁴ Fojut, *supra* note 1, at 170. This principle is referred to as "double criminality." *Id.*

¹³⁵ Montpas, *supra* note 2, at 182.

¹³⁶ See Gorman & Loo, *supra* note 126, at 691-92.

¹³⁷ *Id.* at 691.

¹³⁸ *Id.* at 691-92. "Time is critical in law enforcement, especially in detecting gambling; a gambler is unlikely to play these games for many hours. If the tracing takes longer than a few hours, tracing may not be possible." *Id.* at 692.

¹³⁹ Kish, *supra* note 4, at 463. Encryption, which would make users and operators virtually undetectable, is probably "an illegal casino operator's dream come true and law enforcement's worst nightmare." Gorman & Loo, *supra* note 126, at

The IGPA's passage would likely "only persuade more providers to move to 'safe harbor' jurisdictions or go underground. In fact, as public awareness of the bill increases, virtually all known Internet gambling providers within the United States have sold or relocated their sites."¹⁴⁰ Critics of the IGPA have even argued that, by failing to legalize on-line gambling, supporters of unilateral prohibition are actually *supporting the exportation of gambling benefits*.¹⁴¹ As a result, the IGPA could very well exacerbate the harms it was supposedly designed to prevent.

In light of the considerable enforcement impediments associated with the potential passage of the IGPA, Congress should determine whether it is preferable to spend huge resources in tracking down and prosecuting violators of an Internet gambling ban, or whether an alternate system of regulation and taxation, based on state deference or international agreement, should be utilized.¹⁴² It would also be both irrational and hypocritical for the various state and federal law enforcement agencies to spend huge amounts of human and economic resources in rooting out a vice that is already allowed and *even encouraged* when conducted in *other outlets* in many of the individual states, and regarding a substantive matter that has been dealt with largely by the states. Perhaps Internet gambling can and does promote fraud, money laundering, addiction, etc., but so does gambling in all of its other guises. The notion that Internet gambling alone should be singled out for federal *prohibition* is simply indefensible.¹⁴³

695-96.

¹⁴⁰ Hogan, *supra* note 22, at 851.

¹⁴¹ Kailus, *supra* note 16, at 1077.

¹⁴² *Id.* at 1065.

¹⁴³ See, e.g., Vincent P. Tassinari, *Patenting Gaming Methods for Internet Use: A Managerial Imperative*, 8 NEV. LAW. 10, 10 (2000) (arguing, like virtual casinos, "Las Vegas gambling businesses have faced and continue to face underage gamblers, gambling addicts harming themselves, and gambling related crimes and yet have brought each scourge down to a level that permits legitimate gambling in casinos of Las Vegas.").

V. ALTERNATIVES TO OUTRIGHT FEDERAL PROHIBITION OF INTERNET GAMBLING

A. Federal Licensing and Taxation

Other nations which have confronted the Internet gambling issue, including Australia, have determined that the most prudent method of regulating its growth is to place their seal of approval on Internet gambling so that they can draw gamblers away from unregulated sites and generate tax revenues for their national governments.¹⁴⁴ Such a national policy clearly assumes that "Internet gambling is going to happen, so [the state] may as well be in the best position when it does."¹⁴⁵ Should such policies become widespread and effective in deterring the social ills associated with Internet gambling while also raising needed tax revenues, a significant amount of pressure would likely be placed on other nations,

¹⁴⁴ Kailus, *supra* note 16, at 1077; *see also* Tratos, *supra* note 3, at 114 (arguing only way national governments can make sure that they collect revenues is through licensing of Internet gambling website operators). Belize and Liechtenstein also have such licensing schemes in place, and it appears likely that other countries will follow. Goldstein, *supra* note 39, at 26-27. New Zealand is strongly considering such a national policy whereby government inspectors would "conduct the same type of gaming background checks it does for traditional casino operators and would then analyze the . . . games and gaming mechanisms the virtual casino offers for public consumption." Tratos, *supra* note 3, at 114-15. Such licensing would be provided for a fee, thus creating revenue for the national government. *Id.* at 115.

¹⁴⁵ Kailus, *supra* note 16, at 1077 (citation omitted). Governments proposing such measures have recognized that while Internet gambling does impose significant harms on their populations that will be difficult if not impossible to alleviate, they should at least capitalize on the benefits to be realized from such gambling in the form of increased revenues. *See* Goldsmith, *supra* note 5, at 1120.

Another strong governmental concern worth mentioning revolves around the fact that a total prohibition on Internet gambling would likely drive out of the country those operators who would otherwise comply with state regulatory controls. Karadbil, *supra* note 4, at 431. In particular, the scenario could be likened to the failed 1920s era of Prohibition in that "unscrupulous operators would have greater access to vulnerable consumers than if the government had attempted to regulate the industry at the beginning." *Id.* Thus, a very real consequence of the passage of the IGPA could be the scaring away of "scrupulous operators, leaving behind only those that are willing to break the law to satisfy a very real consumer demand." *Id.*

especially the United States, to follow suit.¹⁴⁶ Thus, unless gambling ceases to exist throughout the world, it is highly unlikely that Americans will ignore Internet gambling's spread as a significant economic opportunity.¹⁴⁷

While federal licensing is certainly a plausible solution to regulating Internet gambling, such a policy should not be adopted by the United States. It would fail to allow the states to make their own individual choices regarding how to deal most effectively with Internet gambling, and it would deprive the individual states of much-needed revenue that they would otherwise realize if the matter were left solely up to them. The respective states vary greatly in their views regarding how, or even if, any form of gambling should be legal. Congress should not go against tradition (as well as the Constitution potentially) and force its own policy preferences upon the states.

B. International Agreements Regarding Internet Gambling

Other commentators have argued that any nation's laws are inadequate to deal with Internet gambling on their own, and, as such, "[a] global resolution, with adequate discussion of the issue, resulting in an agreeable treaty, is ideal."¹⁴⁸ Such an approach would ostensibly circumvent any international conflict of laws dilemmas.¹⁴⁹ As more and more of the larger, industrialized nations seek to participate in such international agreements, the more the Internet as a whole will be regulated.¹⁵⁰ However, the simple fact that one country could, and probably would, allow Internet gambling would destroy the effectiveness of any such international framework.¹⁵¹

Currently there are no international agreements regulating *any facet* of the Internet.¹⁵² It cannot be overstated that

¹⁴⁶ See Tratos, *supra* note 3, at 115.

¹⁴⁷ *Id.*

¹⁴⁸ Goldstein, *supra* note 39, at 31.

¹⁴⁹ *Id.*

¹⁵⁰ Montpas, *supra* note 2, at 183.

¹⁵¹ *Id.* at 183.

¹⁵² *Id.* at 182.

while there are countries, including the United States, that would like to prohibit Internet gambling, there are other countries, such as Monaco, that are aggressively endorsing Internet gambling.¹⁵³ Further, "any attempt by the United States, which recognizes \$52 billion a year in legal gaming revenues, will encounter resistance when telling a small Caribbean country to stop receiving a few million dollars in fees annually from Internet operators."¹⁵⁴ As a result, any international agreement, particularly an effective one, regarding the regulation of Internet gambling remains a distinct impossibility.¹⁵⁵

C. Self-Regulation

Some commentators have also argued that if government regulation is powerless to stop Internet gambling, then the burden must fall on private individuals to control their own gambling proclivities.¹⁵⁶ Proponents argue that the use of filtering techniques, usually in the form of computer programs that limit access to prohibited sites, are available to teachers, parents, and employers who desire to keep their students, children, and employees from gambling on the Internet.¹⁵⁷ The purported benefit of such a system is that it allows persons to choose their own level of censorship without imposing any particular group's beliefs or notions upon another.¹⁵⁸

While such a private regulatory framework may sound appealing upon first impression, its rationale is flawed for two reasons. First, if students or employees are unable to access

¹⁵³ *Id.* At least twenty-four countries already authorize some form of Internet gambling, including Austria, Belgium, Germany, and Finland. *See supra* note 16 and accompanying text; *see also* Karadbil, *supra* note 4, at 446 (arguing that because of wide variations in governmental policy regarding Internet gambling, "[a]n international solution, while the most beneficial, may be the hardest to implement.").

¹⁵⁴ Cabot, *supra* note 23, at 22.

¹⁵⁵ *Id.*

¹⁵⁶ Montpas, *supra* note 2, at 183.

¹⁵⁷ *Id.* at 183-84.

¹⁵⁸ *Id.* at 184.

any material on the Internet because of the perceived harmful nature of such communication, then they clearly have had their teacher or employer act, arguably at least, in a paternalistic way to determine what is appropriate or suitable for another class of person's eyes. Second, it underestimates the ways in which gambling addicts may act to circumvent such controls.¹⁵⁹

The Interactive Gaming Council (IGC), which boasts a membership of seventy Internet gambling sites, has, on the other hand, devised a model code of conduct which it encourages its members to follow.¹⁶⁰ Its provisions include: that the operator will lawfully abide by the regulatory regime of the jurisdiction in which it is located; that all customers will be afforded confidentiality and privacy; that all promotional materials and publications will be truthful (especially with regard to rules and payout ratios); and that each operator will take active measures to preclude gambling by minors and compulsive gamblers.¹⁶¹ While these measures sound appealing in the abstract, it is clear that there is no mechanism to enforce these private regulations and the IGC's membership constitutes only a small portion of the Internet gambling market.¹⁶²

VI. CONCLUSION: A PROPOSAL FOR LEAVING THE ISSUE OF INTERNET GAMBLING TO BE DECIDED SOLELY BY THE INDIVIDUAL STATES

Because of the prohibitive enforcement costs and legal uncertainty associated with a federal prohibition on Internet gambling, a more effective and rational solution is to allow the individual states to craft their own policies regarding Internet gambling. The individual states have already come up with all sorts of successful schemes for regulating gambling in all of its various guises, and though Internet gambling differs in some

¹⁵⁹ Montpas, *supra* note 2, at 184.

¹⁶⁰ Karadbil, *supra* note 4, at 442.

¹⁶¹ *Id.* at 442-43.

¹⁶² *Id.* at 415.

significant ways from those gambling activities which are currently left in the hands of the states, that is no reason to think the states cannot devise their own regulatory schemes to deal with Internet gambling. After all, "if the IGPA becomes law, it might be nothing more than a national moral proclamation—incapable of being enforced and contrary to the traditional views of gambling expressed by most states and their citizens."¹⁶³ States should be allowed to make their own assessments about the desirability and legality of Internet gambling within their borders, rather than have the federal government decide the issue in wholesale fashion.¹⁶⁴

Additionally, the objection voiced by opponents of such a scenario that those states that chose to ban Internet gambling would be left unprotected and without appropriate enforcement mechanisms is without merit.¹⁶⁵ This problem is no different than the international position the United States would be in should it choose to prohibit Internet gambling.¹⁶⁶ Further, allowing states to regulate Internet gambling will likely lead to the growth of legitimate, and perhaps well-known, gambling website operators or traditional casinos willing to submit to licensing in individual states, thereby increasing both consumer confidence and protection.¹⁶⁷ Recent case law suggests that the individual states may not be as helpless in curbing the unchecked growth of Internet gambling as the proponents of the IGPA would suggest.¹⁶⁸

¹⁶³ Kish, *supra* note 4, at 463.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 464.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ See *State v. Granite Gate Resorts, Inc.*, 568 N.W.2d 715, 721 (Minn. Ct. App. 1997), *aff'd*, 576 N.W.2d 747, 747 (Minn. 1998); see also *supra* note 128 and accompanying text (noting how other courts have assessed assertions of personal jurisdiction under similar circumstances).

In *Granite Gate*, perhaps the seminal lawsuit concerning on-line gambling, Minnesota was allowed to assert personal jurisdiction over a Nevada defendant which advertised the wares of WagerNet, a developing Belizian Internet gambling service which was not joined as a party. *Granite Gate*, 568 N.W.2d at 721. The defendant was charged with deceptive trade practices and fraud based on WagerNet's assertion that its bookmaking service was legal. *Id.* at 717. The de-

Enacting a federal ban on Internet gambling, therefore, will be more than a little premature; it "will mean that the opportunity for state experimentation in this area will be lost—replaced by a national law incapable of reflecting the will of citizens of a particular state on an issue where their needs . . . have traditionally been given great deference."¹⁶⁹ Leaving such initiatives to the individual states will best allow the states to remain in line with the popular will of their

defendant contended that it could not be subject to personal jurisdiction in Minnesota because it had not availed itself of the privilege of conducting business in every state from which its information could be accessed. *Id.* at 718. The Minnesota Court of Appeals disagreed, noting that WagerNet's mailing lists included Minnesota residents; persons in Minnesota called its phone line; and that some Minnesota computers were among the 500 that most often accessed WagerNet's Internet site. *Id.* at 718-19. The court also pointed out that WagerNet's site welcomed business from international markets, and included a toll-free phone number. *Id.* at 720. The court stressed that Granite Gate made all of the operating decisions regarding WagerNet, and that by the latter's reserving the right to sue Internet gamblers in any state in which they live, WagerNet could not claim inconvenience when such a state sought to assert personal jurisdiction over it. *Granite Gate*, 568 N.W.2d at 721; *see also* *State v. Coeur D'Alene Tribe*, 164 F.3d 1102, 1109 (8th Cir.) (remanding case to district court to determine whether Indian tribe's Internet lottery is carried out "on Indian lands" or not; if not, then tribe is subject to Missouri's anti-gambling laws), *cert. denied*, 527 U.S. 1039 (1999); *People v. World Interactive Gaming Corp.*, No. 404428/98, 1999 WL 591995, at *3-5 (N.Y. Sup. Ct. July 22, 1999) (trial court's holding that Delaware corporation headquartered in New York City, as well as Antiguan Internet gambling website wholly owned by it, were all subject to personal jurisdiction in New York because all business decisions were made in New York, and virtual casino was alter ego of parent corporation).

Naysayers of leaving the issue of Internet gambling to the individual states will doubtless argue that those gambling websites that legitimately operate in one state would unfairly be subject to personal jurisdiction in other states where Internet gambling would be illegal. This argument ignores the fact that such operators can take pains to assure that their wares are not addressed to such states, including disclaimers about which states it is unable to accept wagers from, and refusing to send payouts to gamblers in such states. Further, those states which chose to prohibit Internet gambling could impose criminal penalties on the players as a substantial deterrent to Internet wagering by their own citizens.

¹⁶⁹ Kish, *supra* note 4, at 466.

respective citizenries and will avoid many of the perplexing constitutional and enforcement problems that will surely arise should the IGPA become law.

David Goodman

Selective Disclosure: “A Fencing Match Conducted on a Tightrope” and Regulation FD—The SEC’s Latest Attempt To “Electrify the Tightrope”

I. INTRODUCTION

I’m concerned about one, increasingly worrisome form of trading on the basis of non-public information. The S.E.C. is watching this situation very closely, and we hope that self-restraint will solve the problem—before we have to step in. The scenario is this: A company has material news that must be communicated to its shareholders and to the markets. The news is big—certainly big enough to move the price of the company’s stock. The company drafts a press release, setting the time for the announcement—and putting an embargo on any disclosure of the news to the general public. Before the public announcement, the company tells the news to some of its favorite Wall Street analysts. Or, it might arrange a conference call with a large number of analysts and selected institutional investors. What happens next we find troubling. In the interval—after the analysts know the news, but before the public knows it—there is a great deal of unusual trading. . . . Legally, you can split hairs all you want. But, ethically, it’s very clear: If analysts or their firms are trading—knowing this information, and prior to public release—it’s just as wrong as if corporate insiders did it I realize that such issues of selective disclosure are very sensitive. But I have two observations. First, it is very clear to me—and to the S.E.C.’s Enforcement Division—that issuers should not selectively disclose information to certain influential analysts, in order to curry favor with them and reap a tangible benefit, such as a positive press spin. Second, you should counsel your clients that—during the window of time in which only some analysts have been told material information—the news has not yet been publicly disseminated. No

one who knows that information should be trading.¹

It was in this much-publicized speech in 1998 that Chairman Levitt first intimated the Securities and Exchange Commission's (the "SEC") disdain for selective disclosure and its intention to eliminate it. However, while Chairman Levitt's desire to prosecute such behavior is unmistakably clear, the status of the law regarding issuer selective disclosure is considerably more vague.²

Selective disclosure is a complex legal concept concerning the disclosure of material, non-public information and has been recognized as a form of insider trading with the attendant liability.³ Selective disclosure occurs where someone acting on behalf of an issuer conveys material, non-public information to someone else who may derive improper personal benefit from its use.⁴ In recent years, selective disclosure has received attention not only from legal scholars and practitioners, but also from "corporate America" and Wall Street investment analysts.⁵ Selective disclosures take place in various situations including conference calls or meetings that are open only to

¹ Arthur Levitt, Remarks at "S.E.C. Speaks" Conference, *A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading* (visited Feb. 27, 1998) <<http://www.sec.gov/news/speeches/spch202.txt>>.

² See Gary G. Lynch, *Disclosure Obligations and the Risk of Selective Disclosure*, at 45, 57 (PLI Corp. Law Practice Course Handbook Order No. BO-OOAO, Nov. 1999).

³ See Steven E. Bochner & Ignacio E. Salceda, *Over the Wall: Handling Securities Analysts' Conference Calls, Earnings Forecasts, and Reports Effectively*, at 131, 135 (PLI Corp. Law Practice Course Handbook Order No. BO-OOAO, Nov. 1999).

⁴ See *id.* A recent study of corporate disclosure practices by the National Investor Relations Institute reported that 26% of responding companies stated that they engaged in some types of selective disclosure practices. *A Study of Corporate Disclosure Practices, Second Measurement*, NAT'L INVESTOR REL. INST., May 1998, at 18.

⁵ See *e.g.*, Susan Pulliam & Gary McWilliams, *Compaq is Criticized for How it Disclosed PC Troubles*, WALL ST. J., Mar. 2, 1999, at C1; Susan Pulliam, *Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data*, WALL ST. J., Oct. 14, 1999, at C1; Randall Smith, *Conference Calls to Big Investors Often Leave Little Guys Hung Up*, WALL ST. J., June 21, 1995, at C1; George Anders & Robert Berner, *Webvan to Delay IPO in Response to SEC Concerns*, WALL ST. J., Oct. 7, 1999, at C16.

analysts and/or institutional investors and exclude other investors, members of the public, and the media.⁶

For a significant period of time the SEC has deemed selective disclosure not to be "in the best interests of investors or the securities markets generally."⁷ As the Supreme Court stated in *United States v. O'Hagan*,⁸ an "animating purpose" of the Securities Exchange Act of 1934 (the Exchange Act) was to promote investor confidence,⁹ and clearly in the opinion of the SEC, the continued practice of selective disclosure posed a serious threat to investor confidence because it undermined the fairness and integrity of the securities markets.¹⁰ Additionally, the SEC is concerned that the continued practice of selective disclosure inevitably will diminish the public's confidence in analysts' reports because of the likelihood that analysts will be

⁶ See Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-787, 34-42259, IC-24209, 64 Fed. Reg. 72,590, 72,592 (1999) [hereinafter Proposed Regulation FD]. Often these situations involve pre-earnings announcement estimates or warnings and often significantly impact the market price of the issuer's securities. *Id.* For example, issuers will disclose the advance warning of earnings results to selected analysts and institutional holders prior to the information being publicly disseminated to the general public (i.e., John Doe—holder of 100 shares of the issuer's security), thereby allowing those privy to the information (i.e., favored analysts and their favored clients) to generate a profit or avoid a loss at the expense of John Doe.

⁷ *Id.* at 72592. In its Release, the SEC acknowledged the beneficial role that analysts play in disseminating information to investors in a useful manner. *Id.* at 72592. Notwithstanding this important role, the SEC has become increasingly troubled by recent reports of selective disclosure and its adverse impact on the securities market. See *supra* note 1 and accompanying text.

⁸ 521 U.S. 642 (1997).

⁹ *O'Hagan*, 521 U.S. at 658. The Release also states that it is critical to protect investors from the possibility of others in the market with access to corporate insiders obtaining "unearned informational advantages." Proposed Regulation FD, *supra* note 6, at 72592.

¹⁰ See Proposed Regulation FD, *supra* note 6, at 72592. Selective disclosure allows those with superior access to information to secure quick profits or avoid losses by trading on such information before it is publicly known. *Id.*; see also Richard Frankel et al., *An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium*, 37 J. ACCT. RES. 133 (Spring 1999). This study found that, during and immediately following analyst conference calls, volume in the company's stock increased as did volatility. *Id.* Thus, the researchers concluded that the material information released during the call was disseminated to a few large investors who immediately traded on the nonpublic information. *Id.*

pressured to report favorably about the issuer in order to maintain access to corporate management.¹¹

Prior to Regulation FD, the SEC has evaluated selective disclosure under an analysis applicable to securities fraud, and particularly insider trading.¹² Under early insider trading law, a corporate insider could be exposed to "tipper" liability by selectively disclosing material, non-public information to analysts and institutional investors.¹³ However, the Supreme Court altered this traditional standard with its decision in the seminal tipping case, *Dirks v. SEC*,¹⁴ where the Court stated that a recipient of inside information is prohibited from trading only when the information is obtained improperly, thereby insulating analysts from liability.¹⁵ In an effort to eliminate the seemingly special treatment afforded to analysts by the *Dirks* decision, the SEC proposed Regulation FD.¹⁶ Regulation FD does not evaluate selective disclosure under the guise of insider trading law. Rather, it addresses selective disclosure

¹¹ See Proposed Regulation FD, *supra* note 6, at 72592; see e.g., Fred Barbash, *Companies, Analysts A Little Too Cozy*, WASH. POST, Oct 31, 1999, at H1 ("Companies coddle analysts to obtain the most favorable coverage which is critical to their stock price. Analysts covet their access to companies, because special knowledge is the only thing they have to offer clients."); Andrew Hill, *Let the Buyer Beware*, FIN. TIMES, Oct. 27, 1999, at 14 ("The death of the 'sell' note is perhaps the clearest signal that big securities houses are suppressing or toning down negative analysis of companies that are clients or potential clients. In a snapshot of 27,700 individual analyst reports, taken at the beginning of this month, First Call/Thompson Financial, the research company, found nearly 70 percent recommended that investors buy the stock and just under 1 percent advised they should sell."); Robert McGough, *One Analyst Anticipated IBM News*, WALL ST. J., Oct. 22, 1999, at C1 ("Too often, analysts rely on executives at the companies they cover to let them know what's going on in the business.").

¹² See Proposed Regulation FD, *supra* note 6, at 72593. See *infra* Part I for a discussion of the SEC's treatment of selective disclosure under insider trading law.

¹³ See *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 15 (2d Cir. 1977); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc).

¹⁴ 463 U.S. 646 (1983).

¹⁵ *Dirks*, 463 U.S. at 663. After *Dirks*, there have been very few cases involving selective disclosure to analysts. See Part I for a more complete discussion of the "Post-*Dirks*" cases.

¹⁶ See Proposed Regulation FD, *supra* note 6, at 72594. See also *supra* notes 36-44 and accompanying text for discussion of SEC's attempts following *Dirks* to impose liability for selective disclosure to analysts.

using the SEC's authority to require full and fair disclosure from issuers under Section 13(a) of the Exchange Act.¹⁷

This comment will examine the highly controversial, and often inconsistent, legal treatment of selective disclosure, and analyze the effectiveness of the SEC's most recent attempt to combat selective disclosure, Regulation FD, in balancing the twin goals of securities regulation: efficiency and fairness. Part I addresses the current state of the law regarding selective disclosure by summarizing prior attempts by the SEC to regulate selective disclosure under insider trading. Next, this comment will analyze Regulation FD to evaluate the effectiveness of the proposal in improving corporate communications with the investment community as a whole. Part III will attempt to clarify and more precisely define some of the ambiguous terms and provisions of the rule. Further, this comment will predict the implications that Regulation FD will have on the disclosure practices of "corporate America." Lastly, this comment will examine the likelihood of Regulation FD having a substantial "chilling" effect on corporate communications with the analyst community and thus imperil the analysts' role in market efficiency.

I. SELECTIVE DISCLOSURE UNDER INSIDER TRADING LAW

The problem of selective disclosure arises most often in the context of communications with analysts.¹⁸ In the past, the SEC has declined to attack selective disclosure by a specific statute or regulation, but instead has attempted to impose liability based on the principles of securities fraud.¹⁹ An early example of the SEC's treatment of selective disclosure in the context of analyst communications is *SEC v. Bausch & Lomb, Inc.*²⁰ In holding for the defendants, the Second Circuit recog-

¹⁷ See Proposed Regulation FD, *supra* note 6, at 72594. Regulation FD is designed as an issuer disclosure rule, similar to existing SEC rules under Exchange Act Section 13(a) and 15(d). See 15 U.S.C. §§ 78m(a) and 78o(d) (1994).

¹⁸ See Lynch, *supra* note 2, at 56.

¹⁹ See generally *Dirks*, 463 U.S. at 646; *Chiarella v. United States*, 445 U.S. 222 (1980); *SEC v. Bausch & Lomb*, 565 F.2d 8 (2d Cir. 1977).

²⁰ 565 F.2d 8 (2d Cir. 1977).

nized the difficulty that corporate executives face in dealing with analysts and analogized the encounters to "a fencing match conducted on a tightrope: [the executive] is compelled to parry often incisive questioning while teetering on the fine line between data properly conveyed and material inside information that may not be revealed without simultaneously disclosing it to the public."²¹ Traditionally, insider trading law imposed liability on both the corporate official and the analyst, if after coming into possession of the material, nonpublic information, the analyst failed to publicly disclose the information or traded on the information.²² However, a series of Supreme Court decisions replaced the traditional liability scheme, based on the "disclose or abstain" rule, with a more liberal standard that requires a breach of fiduciary duty and improper motive on the part of the corporate official disclosing the information in order to impose liability.²³

A. *Chiarella v. United States*

The first step in the abandonment of the traditional liability standard came in the Supreme Court's landmark decision, *Chiarella v. United States*.²⁴ In *Chiarella*, the Court rejected the "parity of information" approach, which considered trading fraudulent if the trader possessed material information that was not generally available to the public.²⁵ In reversing

²¹ *Bausch & Lomb*, 565 F.2d at 9. See William R. DeLuca et al., *Selective Disclosure and Analysts: A Problem Better Solved by Issuers Than Law Enforcement*, at 77-87 (PLI Corp. Law Practice Course Handbook Order No. BO-O-0070, Mar. 1999).

²² See Paul P. Brontas, Jr., Note, *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1528 (1992).

²³ *Id.*; see *Dirks*, 463 U.S. at 663; *Chiarella*, 445 U.S. at 232 (requiring breach of fiduciary duty (i.e., employer-employee, doctor-patient, attorney-client) and improper motive of tipper in order to impose liability).

²⁴ 445 U.S. 222 (1980).

²⁵ *Chiarella*, 445 U.S. at 233-35. Vincent Chiarella was employed by a printing firm and was responsible for printing announcements of corporate takeover bids. *Id.* at 224. The identities of the target companies were concealed by blank spaces or false names. *Id.* However, Chiarella identified the target companies from other information in the documents and began to trade on the non-public information. *Id.* He bought stock in the target companies and sold the shares im-

Chiarella's conviction, the Court stated that the duty of corporate insiders to disclose material information arises from: "(i) the existence of a relationship affording access to inside information intended to be available for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure."²⁶ Because Chiarella was not a corporate insider, an agent or a fiduciary of the shareholders of the target (or the acquiror), he had no duty to disclose or abstain from trading.²⁷

B. *Dirks v. SEC*

Exactly ten years after *Chiarella*, the Supreme Court decided the seminal tipping case of *Dirks v. SEC*,²⁸ which further insulated analysts from insider trading liability.²⁹ In *Dirks*, the Court addressed the derivative nature of "tipping" by an insider to an analyst and the subsequent disclosure by the analyst to its clients.³⁰ In reversing *Dirks*' conviction, the Supreme Court rejected the notion that a person is prohibited from trading whenever he or she receives material, nonpublic information from an insider.³¹ Rather, the Court held that a

mediately following the public announcement of the takeover after amassing a large profit. *Id.* Subsequently, he was criminally convicted of insider trading. *Chiarella*, 445 U.S. at 223.

²⁶ *Id.* at 227 (citing *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961)). Further, the Court stated that the existence of a duty could arise from legislative enactments or certain fiduciary relationships. *Chiarella*, 445 U.S. at 232.

²⁷ *Id.* at 231-37.

²⁸ 463 U.S. 646 (1983).

²⁹ See *Lynch*, *supra* note 2, at 57. In *Dirks*, the SEC charged Raymond Dirks, an investment analyst for the insurance industry, with insider trading. *Dirks*, 463 U.S. at 648. Dirks received material adverse information (company fraud) from "insiders" of a publicly-traded company, Equity Funding of America (Equity Funding). *Id.* at 648-49. Dirks subsequently alerted several institutional investors in Equity Funding, some of whom sold large amounts of stock in reliance on the information before the public disclosure of the adverse information. *Id.*

³⁰ See DeLuca, *supra* note 21, at 85; *Dirks*, 463 U.S. at 659-61. Tipping occurs where an insider or someone with material, nonpublic information passes along such information to an outsider in exchange for some type of personal benefit (i.e., pecuniary gain, sexual favors or reputational enhancement). *Dirks*, 463 U.S. at 660.

³¹ *Id.* at 667. The Supreme Court reversed the United States Court of Appeals

recipient of inside corporate information (the tippee) engages in insider trading only if: (i) the corporate insider (the tipper) breaches his or her fiduciary duty owed to shareholders by divulging the information to the tippee; and (ii) the tippee knew or should have known of such breach by the insider.³² The Court also stated that in determining whether an insider has breached his or her fiduciary duty, the Court must examine "whether the insider personally will benefit, directly or indirectly, from his disclosure."³³ In finding for the analysts, the Court emphasized the importance of encouraging analysts to "ferret out and analyze information" and further communicate this information to their clients.³⁴

for the District of Columbia, which had affirmed the SEC's finding. *Id.* In reversing the conviction, the Court stated that Dirks had not misappropriated or illegally obtained the information about the suspected fraud. *Id.* at 665. Further, Dirks was considered a "stranger to Equity Funding," not a corporate insider for purposes of insider trading. *Id.* Therefore, any liability would have to be derived from the breach of duty of the Equity Funding insiders who disclosed the information to Dirks. *Id.*

³² *Id.* at 662. Specifically, the Court was referring to Rule 10b-5 under the Securities Exchange Act of 1934, which states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make statements made, in light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

³³ *Dirks*, 463 U.S. at 662. The Court stated that in order to determine whether any of the Equity Funding insiders breached their duties, the Court must "focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." *Id.* at 663. The Court noted that the Equity Fund tippers "received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks." *Id.* at 667. Therefore, the insiders' disclosure to Dirks did not constitute a breach of their fiduciary duty to the shareholders. *Id.* As such, no liability could be imposed on Dirks because the first prong of the two-part test was not met. *Id.*

³⁴ *Id.* at 658.

The *Dirks* decision has been widely construed to give considerable latitude to corporate officers making disclosures to selected analysts and, more importantly, to the analysts (and their preferred clients) who receive such inside information.³⁵ Many commentators interpreted the "personal benefit" standard to involve some type of pecuniary gain, and thus corporate insiders took comfort that, absent some financial reward, the *Dirks* personal benefit requirement insulated them from potential liability arising from disclosures to analysts.³⁶

C. Post-*Dirks*

In *Dirks* the Supreme Court acknowledged the analysts' beneficial role in overall market efficiency and thus structured the law to permit continuing selective disclosures to them.³⁷ However, the SEC, in an effort to eliminate the special treatment afforded to analysts by *Dirks*, adopted a broader interpretation of the "personal benefit" standard.³⁸ In *SEC v. Stevens*,³⁹ the SEC brought an enforcement action against

³⁵ See Brontas, *supra* note 22, at 1529. Indeed, after *Dirks*, many believed that corporate communications with analysts "enjoyed a special status." Bochner, *supra* note 3, at 135.

³⁶ Brontas, *supra* note 22, at 1529; see, e.g., HAROLD S. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW, § 9.42[4] (1972); John C. Coffee, Jr., *The SEC and the Securities Analyst*, 205 N.Y. L.J. 1, 5 (1991) (stating that decision "contains a virtual paean to the analyst").

³⁷ See Brontas, *supra* note 22, at 1530; see also *infra* notes 96-100 and accompanying text for discussion of analysts' role in market efficiency.

³⁸ See Bochner, *supra* note 3, at 135-36; see also Brontas, *supra* note 22, at 1530. But cf. Donald C. Langevoort, Essay, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1024-25 (1990) (stating that argument for special treatment of analysts is greatly overstated). In fact, after *Dirks* the SEC took the position that *Dirks* did not change the substantive law of insider trading, but only added a pleading requirement of "reputational benefit to the relevant corporate officer." Lynch, *supra* note 2, at 59; see Alan K. Austin & Clay B. Simpson, *Interacting with Analysts*, in THE ART OF COUNSELING DIRECTORS, OFFICERS & INSIDERS: HOW, WHEN & WHAT TO DISCLOSE, at 89, 97 (PLI Corp. Law Practice Course Handbook Order No. BO-OOBH, 1998) (citing Comm'r Edward H. Fleishman, *Ferretting in the Interstices of S.E.C. Attitudes to Securities Analysis*, Presented to the Eighteenth Annual Securities Regulation Institute, University of California, San Diego, California (Jan. 24, 1991) (as edited and annotated by Comm'r Fleishman) [hereinafter Commissioner's Speech]).

³⁹ SEC v. Stevens, 48 S.E.C. 739 (1991).

Stevens, CEO of Ultrasystems, Inc., alleging that Stevens gave some of its preferred analysts information about Ultrasystems's quarterly earnings prior to a public disclosure.⁴⁰ Although the case eventually settled, the SEC, relying on its broad interpretation of the "personal benefit" standard, argued that Stevens disclosed the information to selected analysts to "protect and enhance" his reputation in the analyst community and thus received a "reputational benefit."⁴¹

The danger of such a broad interpretation of "personal benefit" is that potentially all disclosures to analysts are likely made partially on the basis of personal motivation.⁴² In fact, former SEC Commissioner Fleischman acknowledged that the SEC sought to "electrify the tightrope" in the *Stevens* enforcement action by equating "personal benefit" with "a factor that could be plausibly pleaded in virtually any case involving a routine communication of material information to an analyst in the normal course of duty by a conscientious executive who valued his or her job."⁴³ Therefore, under the SEC's broad in-

⁴⁰ *Id.* Specifically, the SEC charged Stevens with violating 10(b) of the Exchange Act by selectively disclosing material, nonpublic information regarding a downward trend in Ultrasystems's quarterly financials to several favored analysts following the company. *Id.* Two analysts communicated the information to clients, who sold their stock in anticipation of the lowered earnings numbers. *Id.*

⁴¹ *Id.* at *2; see also Brontas *supra* note 22, at 1530; Coffee, *supra* note 36, at 5. In 1984, Stevens was criticized by several analysts for negative surprise earnings announcements and according to the SEC, was injurious to his reputation as a financial executive. *Stevens*, at *2. Therefore in 1987, when Stevens once again was faced with disappointing earnings, he disclosed them to selected analysts one day before the announcement to curry favor with them. *Id.* Stevens eventually settled the action with the SEC after paying \$126,455 in fines. *Id.* at *3.

⁴² Because *Stevens* settled, the expansive position taken by the SEC has not been tested in court. The *Stevens* enforcement action resulted in considerable controversy because many argued that the SEC has constructed a liability standard essentially "trivializing *Dirks*." See Brontas, *supra* note 22, at 1530 (quoting Coffee, *supra* note 36, at 5).

⁴³ Brontas, *supra* note 22, at 1530-31 (quoting Commissioner's Speech, quoted in Carl W. Schneider, *Fencing on the Electrified Tightrope: Shocking Executives Who Value Reputation*, 5 PRENTICE HALL L. & BUS. INSIGHTS 2, 1, 2 (July 1991)). Former Commissioner Fleischman set forth many examples that might fall within the "personal benefits" requirement:

Is the disclosing officer reasonably new to his job? He wants to build a

terpretation, managers faced potential liability for all communications with analysts if "a tangential personal reputational benefit accompan[ie]d a legitimate business purpose."⁴⁴

A few months following *Stevens*, the SEC settled another case, *SEC v. Rosenberg*,⁴⁵ where analysts traded on material, nonpublic information obtained from an insider.⁴⁶ Additionally, in 1996 the SEC settled a case against Fox-Pitt, Kelton Inc. ("Fox-Pitt"), a broker-dealer whose employees traded securities based on nonpublic information obtained in an analyst conference call.⁴⁷ In this enforcement action, the SEC charged Fox-

reputation for himself? Is the disclosing officer long in her job? She wants to reaffirm that she's not riding on her laurels and she wants to create the same reputation among newer analysts.

Has the disclosing officer previously had problems with credibility, by exaggerating in the company's behalf or by being caught by subsequent unexpected events? He's trying to redeem his reputation. Has the disclosing officer a good record and established credibility with the analysts? She's struggling to maintain that reputation.

Id. As indicated by the Former Commissioner's comments, neither experienced, credible executives nor inexperienced, dishonest executives were impervious to such heightened scrutiny.

⁴⁴ Brontas, *supra* note 22, at 1531; see e.g., Bruce A. Hiler, *The SEC and the Insider/Tipper*, 206 N.Y. L.J. 1, 6 (1991) (stating that reputational interest accompanies all voluntary disclosures regardless of legitimate business purpose being present).

⁴⁵ *SEC v. Rauschberg*, No. 91-2403, 1991 SEC LEXIS 2218 (D.D.C. Sept. 24, 1991).

⁴⁶ Lynch, *supra* note 2, at 59. The SEC prosecuted the analysts under slightly different grounds of the misappropriation theory. Under the misappropriation theory, a person is liable for fraud by misappropriating material nonpublic information obtained from a third party for securities trading purposes in breach of a duty of confidence owed by the trader to the third party who may be unrelated to issuer. See *Chiarella v. United States*, 444 U.S. 222, 244 (1980) (Burger, J., dissenting). Analysts generally do not receive information with a duty to maintain its confidentiality. Rather, they are expected to make the information public. Therefore, with the exception of *Rosenberg*, the misappropriation theory has not been recognized as a basis for imputing insider trader liability to analysts resulting from selective disclosure. Cf. *United States v. O'Hagan*, 521 U.S. 642, 655-56 (1997) (holding that criminal liability imposed under Section 10(b) of Exchange Act may be predicated on misappropriation theory).

⁴⁷ Lynch, *supra* note 2, at 60. See *In re Fox-Pitt, Kelton, Inc.*, 1996 WL 657769 (S.E.C. Nov. 12, 1996). The SEC alleged that "a Fox-Pitt analyst received material nonpublic information during a conference call which the issuer held simultaneously with several broker-dealers." *Id.* at *1.

Pitt with violating Section 15(f) of the Exchange Act "by failing to have procedures and practices . . . to prevent the misuse of material, nonpublic information."⁴⁸ However, because these enforcement actions settled, the SEC's expansive and arguably untenable interpretation of the "personal benefit" standard has not been validated in court.

II. REGULATION FD

It is against this backdrop that the SEC proposed Regulation FD. In order to eliminate the uncertainty and vagueness in the law regarding selective disclosure, the SEC proposed and recently finalized Regulation FD, which precludes public companies from selectively disclosing material information to analysts, institutional investors, and others without immediately communicating the same information to the public.⁴⁹ In a departure from its prior attempts to regulate selective disclosure under the guise of insider trading, Regulation FD is designed as an issuer disclosure rule and does not purport to change insider trading law.⁵⁰ Rule 100 of Regulation FD states that whenever:

- (1) an issuer, or any person acting on its behalf,
- (2) discloses material nonpublic information,
- (3) to certain enumerated persons (in general, securities market professionals or holders of the issuer's securities who may well trade on the basis of the information),
- (4) the issuer must make public disclosure of that same information:
 - (a) simultaneously (for intentional disclosures), or

⁴⁸ *Fox-Pitt*, 1996 WL 657769, at *2. Perhaps the most troubling aspect of this action for analysts is that the SEC considered the information to have remained non-public despite the fact that the issuer voluntarily disclosed the information without any type of confidentiality agreement.

⁴⁹ See generally Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881, 34-43154, IC-24599, 65 Fed. Reg. 51,716, (SEC 2000) (to be codified at 17 C.F.R. pts. 240, 243, and 249) [hereinafter Final Regulation FD]. Regulation FD became effective on October 23, 2000. *Id.* at 51716.

⁵⁰ *Id.* at 51716-17. The Rule is promulgated under the SEC's authority to mandate disclosure by public companies. *Id.*

(b) promptly (for non-intentional disclosures).⁵¹

It is important to note that Regulation FD does not mandate that issuers publicly disclose all material developments when they occur.⁵² However, when an issuer makes such a disclosure, it must do so broadly to the public. The key terms and provisions of the Regulation are discussed more extensively below.

A. Materiality

Because the disclosure requirements of Regulation FD apply only to "material" nonpublic information, the most critical analysis involves a proper understanding of what constitutes "material" information. The Regulation does not define "material," but instead relies on the definitions formulated by the courts.⁵³

In *Basic v. Levinson*,⁵⁴ the Supreme Court addressed the issue of materiality and adopted the standards enunciated in *TSC Industries v. Northway, Inc.*⁵⁵ and *SEC v. Texas Gulf Sulphur Co.*⁵⁶ The *TSC Industries* Court held that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if "the disclosure of the omitted fact would have been viewed by the reasonable investor as having

⁵¹ *Id.* at 51719.

⁵² *Id.* at 51716-18. Regulation FD does not mandate that issuers make public disclosure when they occur. Rather, it would require that when an issuer chooses to disclose material, nonpublic information, it does so broadly to the investing public by one of the enumerated methods. See *infra* note 77 and accompanying text for permissible methods. However, the New York Stock Exchange and NASDAQ rules both require listed issuers to disclose promptly "to the public" information regarding all material developments. See NYSE LISTED COMPANY MANUAL, para. 202.05 (*Timely Disclosure of Material News Developments*) and NASD RULES 4310(c)(16), 4320(e)(14), and IM-4210-1 (Disclosure of Material Information).

⁵³ See Final Regulation FD, *supra* note 49 at 51721.

⁵⁴ 485 U.S. 224 (1988).

⁵⁵ 426 U.S. 438 (1976).

⁵⁶ 401 F.2d 833 (2d Cir. 1968) (en banc); see also Brontas, *supra* note 22, at 1523.

significantly altered the 'total mix' of information made available."⁵⁷ The Court in *Basic* stated that materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."⁵⁸

Further, in a recent Staff Accounting Bulletin, the SEC addressed materiality in the context of financial statements.⁵⁹ Although the statements in SAB-99 are directed to financial statements, it is reasonable to infer some guidance with respect to the interpretation of materiality in other contexts.⁶⁰ In its Release, the staff rejected the premonition that misstatements or omissions are immaterial simply because they fall below a numerical threshold.⁶¹ Additionally, the Release states a quantitatively small omission or misstatement might be considered material if the error results in abnormal volatility of the issuer's stock price.⁶² Therefore, at least within the context of

⁵⁷ *TSC Indus. v. Northway, Inc.*, 426 U.S. 449 (1976). TSC Industries involved a lawsuit in which a shareholder alleged that TSC's board of directors intentionally omitted material information from a proxy solicitation. *Id.* at 449.

⁵⁸ *Basic v. Levinson*, 485 U.S. 238 (1976) (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

⁵⁹ See Lynch, *supra* note 2, at 51. In the context of financial statements disclosure, the Financial Accounting Standards Board (the "FASB") also has addressed the issue. *Id.* at 50. The FASB stated that an omission or misstatement of an item in a financial statements is material if, "in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item." *Id.* (citing FASB, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 2, *Qualitative Characteristics of Accounting Information*, 132 (1980)).

⁶⁰ See Lynch, *supra* note 2, at 52.

⁶¹ *Id.* at 52. However, the release surmised that a specified numerical threshold, such as 5%, might be an appropriate first step in the analysis. *Id.* The SEC staff also listed several examples of factors that may make misstatements or omissions below a certain numerical threshold material. *Id.* at 51-52. These include whether the misstatement: Arises from an item capable of precise measurement or arises from an estimate; masks an earnings change or trend; hides a failure to meet analysts' expectations; changes a loss into income or vice versa; concerns an operating segment that is very significant to the registrant's profitability; affects compliance with applicable regulatory requirements, loan covenants, or other contractual requirements; has the effect of increasing management's compensations. *Id.*

⁶² *Id.* at 52. The release states when management expects "that a known mis-

financial statements, "materiality" should not be judged in isolation, but rather in the light of all relevant factors of a company's business.⁶³

While *Basic v. Levinson* may have resolved the confusion in the courts as to the standard of materiality, there remains considerable uncertainty for issuers forced to make "real-time" judgments when pressed with analysts' questions.⁶⁴ Despite the fact that Regulation FD offers no bright-line disclosure standard of materiality, the Release states that certain types of information almost always will be considered material.⁶⁵ However, because the examples in the Release are neither exclusive nor exhaustive, the more difficult and ambiguous questions regarding materiality remain unanswered.⁶⁶

B. Disclosures by "an Issuer or Person Acting on its Behalf"

Under Regulation FD, liability may be imposed not only for selective disclosures made in the name of the issuer but also for selective disclosures made by those "acting on behalf of an issuer."⁶⁷ Therefore, an issuer is responsible only for the dis-

statement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material." *Id.*

⁶³ *Id.*

⁶⁴ See Brontas, *supra* note 22, at 1523. Inevitably, *Basic's* probability/magnitude test remains dependent on a case-by-case analysis of the facts. *Id.*; see also *Greenfield v. Heublin, Inc.*, 742 F.2d 751, 758 (3d Cir. 1984) ("Whether a statement is materially misleading is a mixed question of law and fact . . .").

⁶⁵ See Final Regulation FD, *supra* note 49, at 51721. For example, earnings reports, merger and acquisitions, takeover announcements, new research and development, change in control or management, and events involving issuer's securities (i.e., stock splits) are undoubtedly material because of the immediate, and often significant, impact on the issuer's securities. *Id.* at 51721. However, the Second Circuit held that management's comments about general market trends and the company's ability to take advantage of such trends did not constitute material information. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968). In Regulation FD, the SEC states that "issuers should avoid giving guidance or express warnings to analysts or selected investors about important upcoming earnings or sales figures." Final Regulation FD, *supra* note 49, at 51721.

⁶⁶ *Id.* However, it is likely that suggestions to an analyst to rethink his or her earnings estimates would be considered material. *Id.*

⁶⁷ *Id.* at 51720. Rule 101(c) defines this term as (1) any senior official of the

closures of those representatives who are properly authorized or designated to speak to the public. This distinction abates the fear that an issuer could be automatically liable whenever an employee or agent *improperly* trades or tips based on material nonpublic information.⁶⁸

C. "Certain Enumerated Persons"

Because the regulation is designed to address the core problem of selective disclosures made to those people who will likely trade on such information, Rule 100(b)(1) expressly states Regulation FD will apply only to disclosures made to four categories: (i) broker-dealers and their associated persons, (ii) investment advisers, certain institutional investment managers, and their associated persons, (iii) investment companies, hedge funds, and affiliated persons; and (iv) any holder of the issuer's securities under such circumstances which it is reasonably foreseeable that such person would trade based on the information.⁶⁹ Additionally, Rule 100(b)(2) sets forth four other exclusions from coverage, including disclosure made to "temporary insiders," any persons who expressly agree to maintain the information in confidence, credit-rating entities, and any disclosures made in connection with most offerings of securities under the Exchange Act.⁷⁰

issuer or (2) any other officer, employee, or agent of an issuer who regularly communicates with "certain enumerated persons" as defined *infra* notes 68-69. *Id.* at 51721.

⁶⁸ *Id.* In this situation, the employee or agent would be liable under insider trading law. However, the issuer would not be forced to make a disclosure mandated by Regulation FD. *Id.* at n.37. The Rule would also not apply if the issuer disclosed information to someone who owed him or her any type of duty or trust or confidence (i.e., medical professional). *Id.*

⁶⁹ *Id.* at 51719-20 (to be codified at 40 C.F.R. Part 243.100(b)(1). As proposed, Regulation FD would have applied to "any officer, director, employee, or agent of an issuer." See Proposed Regulation FD, *supra* note 6, at 72594. However, many commenters feared that the proposed language would interfere with ordinary and routine business communications, including communications with customers, suppliers, strategic partners. See Final Regulation FD, *supra* note 49, at 51720. In response to these comments, the Commission narrowed the coverage in the final regulation. *Id.*

⁷⁰ Final Regulation FD, *supra* note 49, at 51720. The primary exclusion is for

D. Intentional and Non-Intentional Disclosures

A disclosure is considered "intentional" when the person making the disclosure either knew or was reckless in not knowing that the information contained in the disclosure was both material and nonpublic.⁷¹ Intentional disclosures might include private conference calls or meetings with selective analysts or investors that were held for the purpose of disclosing material nonpublic information.⁷² By contrast, an inadvertent mistake (i.e., a slip of the tongue during a conference call) or a mistaken belief (not a reckless disregard) that information was already public or immaterial would not be characterized as intentional.⁷³

The distinction is critical because Regulation FD does not require a simultaneous public disclosure if an issuer makes an unintentional disclosure,⁷⁴ but rather a "prompt" one.⁷⁵ "Promptly" is defined "as soon as reasonably practicable" (but no later than 24 hours) after a "senior official" is aware that an intentional disclosure has occurred.⁷⁶

Under Regulation FD, an issuer will be required to make the public disclosure through one of the following alternative methods: filing a Form 8-K with the SEC, disseminating a press release containing the information with a widely circulated news service, or any other method "reasonably designed to provide broad public access" and does not exclude any members of the public.⁷⁷

disclosures to a person owing the issuer a duty of trust or confidence (i.e., "temporary insider"). This would include attorneys, accountants, and investment bankers working for the issuer. *Id.*

⁷¹ *Id.* at 51722.

⁷² *Id.*

⁷³ *Id.* It is likely from the language of the Release that an issuer's mistaken (but not reckless) belief that information is immaterial would be viewed as unintentional. *Id.*

⁷⁴ *Id.*

⁷⁵ Final Regulation FD, *supra* note 49, at 51720. The Release states that the separate requirement for unintentional disclosures recognized that corporate officials may make mistakes without intentionally making selective disclosures.

⁷⁶ *Id.* It seems that the definition of "prompt" is to be used solely for purposes of Regulation FD and is not meant to apply in other contexts in securities laws. *Id.*

⁷⁷ *Id.* at 51723. This includes a press conference to which the public is

E. Liability Issues

As noted above, Regulation FD is an issuer disclosure rule, not an antifraud rule.⁷⁸ As such, no private liability would arise from an issuer's failure to make a proper disclosure.⁷⁹ In fact, to ensure that private liability would not attach, Regulation FD expressly states that a failure to make a disclosure required solely by this provision would not be subject to Rule 10b-5 liability.⁸⁰ However, an issuer's failure to comply with the Regulation would result in an SEC enforcement action, in which the SEC could bring either an administrative action or a civil action.⁸¹ Under certain circumstances, the SEC also could bring an enforcement action against the official of the issuer who engages in selective disclosure.⁸²

Regulation FD does not purport to change or undermine the traditional bases of liability under Rule 10b-5.⁸³ Thus, an

granted access by telephonic or electronic transmission. *Id.* Additionally, issuers may disseminate information by posting the information on the issuer's website. *Id.*; see *A Study of Corporate Disclosure Practices, Second Measurement*, NAT'L INVESTOR REL. INST., May 1998, at 9, 21 (explaining that 82% of responding issuers used their websites to post quarterly results). However, the Release states that a website posting by itself would not be sufficient to constitute public discourse. See Final Regulation FD, *supra* note 49, at 51724. Additionally, the SEC modified the language of the legislation to note that issuers may use a combination of methods to make the disclosure. *Id.*

⁷⁸ *Id.* at 51726. As such, duties arise only under Section 13(a) and 15(d) of the Exchange Act. *Id.* Because Regulation FD is not an antifraud rule, it is not intended to create duties under Section 10(b) of the Exchange Act. *Id.*

⁷⁹ Final Regulation FD, *supra* note 49, at 51726. As stated in the Release, courts have held that there is no implied private right of action under Section 13(a). *Id.* See *e.g.*, *Lamb v. Phillip Morris, Inc.*, 915 F.2d 1024 (6th Cir. 1990); *J.S. Serv. Ctr. Corp. v. General Elec. Tech. Servs. Co.*, 937 F. Supp. 216 (S.D.N.Y. 1996) (holding that no private cause of action was created under Section 13(a)).

⁸⁰ See Final Regulation FD, *supra* note 49, at 51718.

⁸¹ *Id.* at 51726. Under the administrative action the SEC would seek a cease and desist order. *Id.* In a civil action, the SEC might seek an injunction and/or money penalties. *Id.*

⁸² *Id.* The officer could be liable because he or she is the "cause of" the violation or "aided and abetted" the violation. *Id.*

⁸³ *Id.* Additionally, an issuer's failure to make a disclosure may give rise to liability under a "duty to correct" or "duty to update" theory. *Id.* See generally *Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990) (holding defendant liable for failure to update information adequately).

issuer would not be immune to "tipper liability" under Rule 10b-5, provided the allegation satisfies the "personal benefit" standard.⁸⁴ Further, an issuer could incur liability for any public disclosure containing false, omitted or misleading information.⁸⁵

III. IMPLICATIONS FOR ISSUERS

Many commenters argue that Regulation FD will have a dramatic adverse impact on the way public companies communicate with "the Street."⁸⁶ Most notably, issuers and their top officials will be exposed to considerably greater risk when communicating with analysts. In its Release, the SEC asserts that such risks may be alleviated in several ways, many of which are currently being used by a majority of public companies to guard against selective disclosures.⁸⁷ However, all publicly-traded companies should undertake an extensive review of their practices of communicating with analysts and large institutional investors in order to assess any changes necessitated by Regulation FD.⁸⁸ In addition to those posited by the SEC,

⁸⁴ See Final Regulation FD, *supra* note 49, at 51726. See also *supra* notes 27-33 and accompanying text for a discussion of the "personal benefit" standard formulated in *Dirks*.

⁸⁵ See Final Regulation FD, *supra* note 49, at 51726. Moreover, if the issuer filed a Form 8-K containing false or misleading information, Section 18 of the Exchange Act would apply. *Id.*

⁸⁶ *Id.* The Release concedes that issuers might become much more cautious in communicating with analysts and therefore may consult with legal counsel much more frequently. *Id.* In fact, the proposal prompted almost 6,000 comment letters. *Id.* at 51717.

⁸⁷ See Proposed Regulation FD, *supra* note 6, at 72594. Among the SEC's suggestions for issuers are the following: (i) designate a limited number of spokespersons "who are authorized to make disclosures" and answer questions from analysts, investors, or the media; (ii) ensure that a record is kept "of the substance of private communications with analysts or selected investors" (e.g., have more than one person present during contacts or by recording all conversations); (iii) company personnel may decline to answer questions until they have had an opportunity to discuss with others; and (iv) secure a limited confidentiality agreement with analysts not to use or disseminate the information until the issuer has opportunity to review the substance of the conversation and, if deemed necessary, to engage in a consultation to resolve any issues of materiality. *Id.* at 72594-95.

⁸⁸ *Id.* The SEC argues that in many instances the proposal will reinforce

many commentators advocate other precautionary measures to mitigate the risk of selective disclosure.⁸⁹

A seemingly positive effect of Regulation FD is that it will likely accelerate the trend towards freer information for all investors.⁹⁰ Indeed, a solution contemplated by Regulation FD is to open analysts' calls to the media and all investors.⁹¹ In today's world of self-directed, online investors, issuers can use a variety of effective methods, such as webcasting and teleconferencing, to communicate directly with its shareholders in real time without an intermediary such as an analyst.⁹² As such, technological limitations should no longer provide an

adherence to fundamental investor-relations practices. *Id.* It is uncertain, however, if companies will be comfortable relying on those procedures when confronted with the more extensive requirements of Regulation FD.

⁸⁹ See Bochner, *supra* note 3, at 138 (suggesting that companies should adopt a two-fold "no-comment" policy). First, companies should maintain a blackout policy with analysts at the end of a quarter to reduce the likelihood of inadvertently making a selective disclosure. *Id.* Second, the article suggests that companies do not hold analyst conference calls until after the announcement of quarterly earnings. *Id.* Another commentator distilled ten pieces of advice for public companies that are "intended to create a framework to contain the obvious risks without muzzling the messenger." Karl A. Groskaufmanis, *Getting—or Not Getting—the Word Out, Disclosure for Analysts, Investors and the Press*, BUS. L. TODAY, Aug. 1999, at 38, 40. These guidelines include: "limit the number of spokespersons," invoke the "safe harbor" of the Private Securities Litigation Reform Act of 1995, disseminate news broadly, script all disclosures, manage earnings expectations with great care, prepare for a "one-on-one" meeting with investors," update predictive disclosure, "treat media contacts as a separate breed," think about your words in a newspaper, and tell the truth. *Id.* at 40-43.

⁹⁰ See Proposed Regulation FD, *supra* note 6, at 72590-92. In fact, this is the overriding goal of Regulation FD—"to level the playing field" for all investors. *Id.* at 72592. In enacting the disclosure system of the Exchange Act, Congress's intent was to promote disclosure of "honest, complete, and correct information." *Id.* at 72591. See S. REP. NO. 73-1455, at 68 (1934).

⁹¹ See Final Regulation FD, *supra* note 49, at 51717. The Release states that, because of the advancement in technology, issuers have the capability of reaching a vast investor audience with their disclosures and therefore do not need to rely on analysts to broadly disseminate the information. *Id.* For example, EDGAR permits investors to almost instantaneously access information after it is filed with the SEC.

⁹² *Id.* See e.g., *Investor Relations Officers Report Drastic Change in Ways Companies Communicate with Key Audiences*, NAT'L INVESTOR REL. INST., June 18, 1999; Lynn Cowan, *Web Broadcasts of Conference Calls Creates Buzz*, WALL ST. J., May 24, 1999, at B9D.

excuse for issuers. However, the potential downside to freer access is that plaintiffs' securities class-action lawyers will also have immediate access to such information on which to base their claims—a very legitimate fear for public companies.⁹³

IV. "CHILLING EFFECT" ON CORPORATE COMMUNICATION AND MARKET EFFICIENCY

Lastly, many commenters, including both academicians and practitioners, have voiced concern that Regulation FD will have a substantial "chilling effect" on corporate communications.⁹⁴ As noted in Part II-A, what constitutes "material" information remains a somewhat nebulous determination for issuers faced with analyst questions. Many commenters argue that because of this uncertainty, issuers are likely to become overly cautious in communicating with analysts, thereby significantly reducing the information that is eventually filtered to all investors.⁹⁵

Further, it is uncertain whether Regulation FD comports with a theory enhancing overall market efficiency.⁹⁶ One might argue that Regulation FD discounts the positive role that analysts play in the timely dissemination of material information to investors and thus "imperils both the informational and fundamental efficiency mechanisms of the securities

⁹³ See e.g., Bochner, *supra* note 3, at 139-40 (asserting that "a tape or transcript of the conference call just gives the plaintiff's lawyer something to distort in a lawsuit"). The article also warns about placing conference calls on company's websites because of the danger of the court viewing it as a written communication, which has different requirements for safe harbor protection than oral statements. *Id.* at 140.

⁹⁴ See Final Regulation FD, *supra* note 49, at 51718. In fact, in proposing Regulation FD, the SEC sought comment on "whether the use of the procedures discussed above or similar procedures can significantly reduce the risk of 'chilling' the flow of corporate information to the marketplace." Proposed Regulation FD, *supra* note 6, at 72595.

⁹⁵ See Final Regulation FD, *supra* note 49, at 51721.

⁹⁶ In proposing the Regulation, the SEC stated that "[b]y enhancing investor confidence in the markets . . . the proposed Regulation will encourage widespread investor participation in [the] markets, which will enhance market efficiency and liquidity, and foster more effective capital raising." Proposed Regulation FD, *supra* note 6, at 72605.

market."⁹⁷ Many academicians assert that "investment analysts are crucial players in the mechanisms of marketplace efficiency" because they "lead to [the] optimal allocations of capital resources."⁹⁸ In fact, many posit that, because the *Dirks* Court encouraged analysts to "ferret out and analyze information,"⁹⁹ more "useful and accurate information [is] reflected in the prevailing market price of [an] issuer's security."¹⁰⁰

⁹⁷ See e.g., Brontas, *supra* note 22, at 1549. Brontas argues that a securities market is "efficient when stock prices fully reflect all available information [that is relevant to the stock's intrinsic value.]" *Id.* at 1533. Furthermore, Brontas argues, an efficient market must achieve two types of efficiency: fundamental and informational. *Id.* at 1533-34. Fundamental efficiency occurs when stock prices accurately reflect the "fundamental worth of [the] corporation . . . which equals the discounted present value of the corporation's expected future earnings." *Id.* (citing Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 968-69 (1991)). Because market prices influence the larger economy, "fundamental efficiency permits the proper allocation of capital and other resources to the corporations that can use them most productively" and beneficially. *Id.* (citing John C. Coffee, Jr. *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 734-35 (1984)). A market is informationally efficient whenever any new relevant information is promptly reflected in the stock price. Brontas, *supra* note 22, at 1549. Informational efficiency benefits individual investors because such prompt inclusion of relevant information in stock prices ensures equal access to information (i.e., no one possesses an unfair informational advantage). *Id.* (citing JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATION, 498-99 (3d ed. 1989)).

⁹⁸ See e.g., Brontas, *supra* note 22, at 1540. Brontas argues that analysts activities benefit both corporations and overall market efficiency in several ways. *Id.* First, by disclosing information to analysts, a corporation can partially disclose material information that, because of confidentiality concerns, it would prefer not to disclose fully. *Id.* (citations omitted). Second, disclosure to analysts reduces a corporation's fear of liability for speculating on future prospects, thereby ensuring some type of forward-looking information reaches the market. *Id.* Third, disclosure to analysts allows a more sophisticated level of communication because analysts can simplify the substantive content which results in a more sophisticated market analysis of the information's impact. *Id.* Fourth, disclosure to analysts result in more truthful information because selective disclosure ensures that the information will be thoroughly examined by objective experts before it reaches the investing public. Brontas, *supra* note 22, at 1540. Consequently, corporations appear more credible and the overall quality of information improves. *Id.* Lastly, "corporate communications to analysts increase [the] analysts' incentive to cover more corporations," which benefits all investors because it minimizes the cost of obtaining material information. *Id.* (citations omitted).

⁹⁹ *Dirks v. SEC*, 463 U.S. 646, 658 (1983).

¹⁰⁰ See Langevoort, *supra* note 37, at 1024. Indeed, information obtained by the analysts is often the basis for judgments as to the market worth of an issuer's

Indeed, many argue that the current "balance between good investor relations practice and wise SEC guidance has made the American markets the most transparent, popular, and safest in the world."¹⁰¹ Moreover, the Supreme Court's acknowledgment of the invaluable role that analysts play in market efficiency is at the heart of a policy encouraging selective disclosure.¹⁰² However, Regulation FD potentially could eliminate the balance that *Dirks* struck between efficiency and fairness concerns.¹⁰³ In fact, many commentators argue that "the [primary] goal of securities regulation should not be to provide a 'level playing field,'"¹⁰⁴ as Chairman Levitt asserts, but rather to serve the twin purposes of controlling fraudulent activities while still "encouraging the search for and [broad] dissemination of [corporate] information."¹⁰⁵ Therefore, if the result of Regulation FD is to effectively "chill" voluntary corporate disclosures to analysts, this second goal is imperiled and could lead to adverse consequences for the securities markets.

V. CONCLUSION

The issue of selective disclosure will continue to receive increasing attention not only from the SEC and corporate practitioners, but also from investors on Wall Street to "Main

securities. *Dirks*, 463 U.S. at 658-59.

¹⁰¹ Morgan McCall Molthrop, *Investor Relations: Human Nature, the SEC, and Teleconferences*, 2 No. 11, Wallstreetlawyer.com: SEC. ELECT AGE 21, April 1999.

¹⁰² See Broutas, *supra* note 22, at 1548-49 (arguing that the SEC's enforcement action in *Stevens* threatens this policy).

¹⁰³ In *Dirks*, the Court distinguished between two types of insider trading: legal and illegal. *Dirks*, 463 U.S. at 660. The Court deemed corporate communications to analysts to be legal, despite the fact that the analyst could use the information to make a profit, because the analysts obtained the information through proper means. See Broutas, *supra* note 22, at 1548. In illegal insider trading the information is obtained through improper means. *Id.* In making this distinction, Broutas argues that the Court seemed to acknowledge that the market will profit from the former type because uninformed investors will receive the information more quickly. *Id.*

¹⁰⁴ See e.g., Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 669-70 (1988).

¹⁰⁵ See Broutas, *supra* note 22, at 1549.

Street" as participation in the U.S. securities markets continues to accelerate. Perhaps more than any other area in securities regulation, the SEC and the courts must continually seek to balance the competing interests of fairness and efficiency. Many argue that the current liability scheme promulgated in *Dirks* effectively balances these goals by distinguishing between traditional insider trading and corporate communications with analysts. However, Regulation FD is much stricter in its application, effectively proscribing all types of selective disclosure of "material" information, including, most importantly, communications with analysts. Because the definition of "material" is at best imprecise and at worst unworkable, insiders are left with the unenviable task of concluding for themselves what constitutes "material" information. It is this unpredictability, many argue, that ineluctably will result in a substantial "chilling effect" on the market. While many questions surrounding selective disclosure remain unanswered, it is certain that Regulation FD will significantly impact how "corporate America" speaks to the "Street," and if the SEC is successful, how the regulation will shift the legal balance from efficiency to fairness.

Clay Richards

RECENT DECISIONS

CONSTITUTIONAL LAW—FIRST AMENDMENT—APPLICATION OF PUBLIC ACCOMMODATIONS LAW VIOLATES FIRST AMENDMENT WHEN ORGANIZATION'S EXPRESSIVE ACTIVITY IS SIGNIFICANTLY BURDENED*

I. FACTS

James Dale held the position of assistant scoutmaster of Troop 73 for the Boy Scouts of America.¹ In July 1990, the Boy Scouts of America and the Monmouth Council (hereinafter collectively referred to as Boy Scouts) revoked Dale's position and adult membership when it discovered that Dale is "an avowed homosexual and gay rights activist."² In 1992, Dale

* Outstanding Case Note Award, presented by the law firm of Ott & Purdy, Ltd. of Jackson, Mississippi.

¹ Boy Scouts of Am. v. Dale, 120 S. Ct. 2446, 2449 (2000).

² Dale, 120 S. Ct. at 2449. The Boy Scouts is a private, non-profit organization which inculcates its system of values in young people. *Id.* The Monmouth Council is a division of the Boy Scouts of America. *Id.* Dale joined Monmouth Council's Cub Scout Pack at age eight and became a Boy Scout three years later. *Id.* Seven years later, Dale achieved the high honor of Eagle Scout. *Id.* Dale obtained the position of assistant scoutmaster in 1989. Dale, 120 S. Ct. at 2449. Dale was the co-president of the Lesbian/Gay Alliance at Rutgers University. *Id.* In July 1990, Dale appeared in a newspaper article which identified him as the co-president of the Lesbian/Gay Alliance and stated his opinion that homosexual

filed a complaint against the Boy Scouts in the New Jersey Superior Court, claiming the Boy Scouts had violated New Jersey's public accommodations statute and its common law by revoking Dale's membership strictly on the basis of his sexual orientation.³

The New Jersey Superior Court, Chancery Division, granted summary judgment in favor of the Boy Scouts.⁴ The Appellate Division of the New Jersey Superior Court affirmed the dismissal of Dale's common-law claim, but reversed and remanded as to the other claims for further proceedings.⁵ The New Jersey Supreme Court affirmed the appellate division's judgment.⁶ The United States Supreme Court granted certio-

teens needed gay role models. *Id.* In late July, Dale received a letter from Monmouth Council Executive James Kay revoking his adult membership and assistant scoutmaster position. *Id.* When Dale inquired the reason for his release, he received a letter from Kay stating that the Boy Scouts of America "specifically forbid[s] membership to homosexuals." *Id.*

³ *Id.* The New Jersey public accommodations statute prohibits discrimination on the basis of sexual orientation in any place of public accommodation. *Id.* at 2449-50 (citing N.J. STAT. ANN. § 10:5-4 to -5 (West 2000)). Dale sought the following relief: "(1) a declaration that his rights under the New Jersey statute had been violated when his membership was revoked; (2) an order reinstating his membership; and (3) compensatory and punitive damages." *Id.* at 2464 n.6 (Stevens, J., dissenting).

⁴ *Id.* at 2450. The New Jersey Superior Court held that the Boy Scouts was not a place of public accommodation, but was a private organization. *Id.* Therefore, the New Jersey public accommodations statute does not apply to the Boy Scouts. *Id.* The court rejected Dale's common-law claim because New Jersey's policy is incorporated in its public accommodations statute. *Id.* "The court also concluded that the Boy Scouts' position in respect of active homosexuality was clear and held that the First Amendment freedom of expressive association prevented the government from forcing the Boy Scouts to accept Dale as an adult leader." *Dale*, 120 S. Ct. at 2450.

⁵ *Id.* The appellate division held that New Jersey's public accommodations law did apply to the Boy Scouts and that the Boy Scouts violated it. *Id.* The appellate division also rejected the Boy Scouts' federal constitutional claims. *Id.*

⁶ *Id.* The New Jersey Supreme Court addressed the Boy Scouts' federal constitutional claims and held that the Boy Scouts was not "sufficiently personal or private to warrant constitutional protection under the freedom of intimate association." *Id.* (citing *Board of Dirs. of Rotary Int'l v. Rotary Club of Duarte*, 481 U.S. 537, 546 (1987)). The court also held that the Boy Scouts was not entitled to the right of expressive association because the court was "not persuaded . . . that a shared goal of Boy Scout members is to associate in order to preserve the view that homosexuality is immoral." *Id.* The court also held "that Dale's membership

rari and held: reversed and remanded.⁷ The Court held that where the presence of an avowed homosexual significantly burdens the Boy Scouts' ability to express its views, the application of New Jersey's public accommodations law requiring the Boy Scouts to include that person violates the Boy Scouts' First Amendment right of expressive association.⁸

II. RELATED LAW

A. *Expressive Association*

The Supreme Court addressed the issue of the exclusion of an unwanted group from a privately-organized parade in *Hurley v. Irish-American Gay, Lesbian and Bisexual Group of Boston*.⁹ In *Hurley*, the Irish-American Gay, Lesbian and Bisexual Group of Boston (GLIB) claimed that Massachusetts' public accommodations law required the private organizers to include them in the St. Patrick's Day parade.¹⁰ The Court

does not violate the Boy Scouts' right of expressive association because his inclusion would not 'affect in any significant way [the Boy Scouts'] existing members' ability to carry out their various purposes.'" *Id.* (citing *Duarte*, 481 U.S. at 548).

⁷ *Dale*, 120 S. Ct. at 2458. The Court disagreed with the New Jersey Supreme Court's "expressive association" analysis and its opinion that Dale's presence would not significantly burden the Boy Scouts' expressive activity. *Id.* at 2454-55.

⁸ *Id.* at 2457. The Court held that the State's interest in eliminating discrimination did not justify the infringement on the Boy Scouts' right of "expressive association." *Id.*

⁹ 515 U.S. 557 (1995).

¹⁰ *Hurley*, 515 U.S. at 561. The Massachusetts law prohibits discrimination, among other things, on the basis of sexual orientation in places of public accommodation. MASS. GEN. LAWS ANN. ch. 272, § 98 (West 1992); see also *Romer v. Evans*, 517 U.S. 620, 626-27 (1996) (describing public accommodation laws for various municipalities within the State of Colorado); Marissa L. Goodman, Note, *A Scout is Morally Straight, Brave, Clean, Trustworthy . . . and Heterosexual? Gays in the Boy Scouts of America*, 27 HOFSTRA L. REV. 825, 849 (1999) (explaining how Court in *Hurley* held that "the Council's selection process . . . was not a public accommodation, but rather an exhibition of free speech"); Andrew M. Perlman, *Public Accommodation Laws and the Dual Nature of the Freedom of Association*, 8 GEO. MASON U. CIV. RTS. L.J. 111, 119-20 (1997-98) (stating that "public accommodation statutes serve at least three interests: (1) the interest in equal treatment traditionally associated with these statutes; (2) the promotion of human flourishing; and (3) the protection of human dignity").

rejected GLIB's claim and held that the forced inclusion of a group expressing different views than those the organizers wished to express violated the First Amendment.¹¹ The Court reasoned that the selection of parade participants was entitled to the protection of the First Amendment.¹²

¹¹ *Hurley*, 515 U.S. at 581. "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances." U.S. CONST. amend. I. The Court stated that the First Amendment not only protects the freedom to speak, but also protects the freedom not to speak. *Hurley*, 515 U.S. at 573. The Court reasoned that the forced inclusion of an unwanted group would force the private organizers to convey a message they wished to exclude. *Id.* at 572-73; see also Cara J. Frey, Comment, *Hate Exposed to the Light of Day: Determining the Boy Scouts of America's Expressive Purpose Solely From Objective Evidence*, 75 WASH. L. REV. 577, 588 (2000) (explaining how "Court's acceptance of the parade organizers' assertion that by excluding GLIB, it did not intend to exclude gays and lesbians from the parade, but instead declined to include GLIB's message" was central to Court's holding); see also *Texas v. Johnson*, 491 U.S. 397, 414 (1989) (stating that government cannot prohibit expression merely because society disagrees with it); *Democratic Party of the United States v. Wisconsin ex rel. La Follette*, 450 U.S. 107, 123-24 (1981) (stating "a State, or a court, may not constitutionally substitute its own judgment for that of the Party"); *Healy v. James*, 408 U.S. 169, 187-88 (1972) (holding that state can not prohibit expressive activity merely because it considers group's expression objectionable).

¹² *Hurley*, 515 U.S. at 581. The Court stated that First Amendment protection is not restricted to written and spoken forms of expression. *Id.* at 569. The Court reasoned that "a private speaker does not forfeit constitutional protection simply by combining multifarious voices, or by failing to edit their themes to isolate an exact message as the exclusive subject matter of the speech." *Id.* at 569-70; see also *Gregory v. Chicago*, 394 U.S. 111, 112 (1969) (stating parades are forms of protected expression); *West Virginia State Bd. of Educ. v. Barnette*, 319 U.S. 624, 632 (1943) (stating "[s]ymbolism is a primitive but effective way of communicating ideas"); Frey, *supra* note 11, at 588 (explaining since Court applied "lenient approach," the parade organizers had no burden of proving the parade's expressive purpose or, more generally, that the parade had a specific message"); David J. Treacy, Casenote, *First Amendment—Freedom of Association—Membership Organizations Covered Under New Jersey's Law Against Discrimination Have No Protectable Interest to Justify Terminating Boy Scout Members Based on Sexual Preference*—*Dale v. Boy Scouts of America*, 160 N.J. 562 (1999), Cert. Granted, 2000 WL 21144 (J.S.J.J. Jan 14, 2000) (No. 99-699), 10 SETON HALL CONST. L.J. 577, 606 (2000) (stating Court's announcement "that parades are inherently expressive in nature").

B. Significant Burden

In *Board of Directors of Rotary International v. Rotary Club of Duarte*,¹³ the Court addressed the issue of whether the application of California's Unruh Civil Rights Act requiring Rotary Clubs to admit women as members violated the First Amendment.¹⁴ In *Duarte*, a local Rotary Club and two of its female members claimed that Rotary International violated the California Unruh Civil Rights Act when it revoked the local charter of the club and terminated its membership for admitting women as members.¹⁵ The Court held that the application of the Unruh Civil Rights Act requiring admission of women in the local Rotary Clubs did not violate the First Amendment.¹⁶ The Court reasoned that the application of the Act did not significantly interfere with the members' freedom

¹³ 481 U.S. 537 (1987).

¹⁴ *Duarte*, 481 U.S. at 539. The Court considered separately "the effect of the challenged state action on individuals' freedom of private association and their freedom of expressive association." *Id.* at 544-45.

¹⁵ *Id.* at 541. Rotary Club membership was limited to men, but women were allowed to "attend meetings, give speeches, and receive awards." *Id.* Rotary International claimed the restriction on women membership promoted male fellowship and was more compatible with foreign cultures. *Id.* The California Unruh Civil Rights Act states, "All persons within the jurisdiction of this state are free and equal, and no matter what their sex . . . are entitled to the full and equal accommodations, advantages, facilities, privileges, or services in all business establishments of every kind whatsoever." CAL. CIV. CODE § 51 (West 1982). *See Curran v. Mount Diablo Council of the Boy Scouts of Am.*, 952 P.2d 218, 235 (Cal. 1998) (holding that Boy Scouts of America is not considered business establishment under Unruh Civil Rights Act); *Schwenk v. Boy Scouts of Am.*, 551 P.2d 465, 469 (Or. 1976) (holding that Oregon's Public Accommodation Act did not apply to Boy Scout groups); *see also Welsh v. Boy Scouts of Am.*, 993 F.2d 1267, 1275 (7th Cir. 1993) (holding that Boy Scouts is not place of public accommodation); *Seabourn v. Coronado Area Council, Boy Scouts of Am.*, 891 P.2d 385, 406 (Kan. 1995) (holding that Boy Scouts is not place of public accommodation). Courts have also ruled on public accommodation laws regarding other matters. *See Hudson v. Charlotte Country Club, Inc.*, 535 F. Supp. 313, 317 (W.D. N.C. 1982) (holding that private club was not subject to Civil Rights Act); *National Org. for Women v. Little League Baseball, Inc.*, 318 A.2d 33, 37-38 (N.J. 1974) (holding that baseball field was considered place of public accommodation).

¹⁶ *Duarte*, 481 U.S. at 537; *see New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (stating "[d]enial of the right to experiment may be fraught with serious consequences to the Nation").

of private association or their freedom of expressive association.¹⁷

In *New York State Club Association, Inc. v. City of New York*,¹⁸ the Court addressed the issue of the constitutionality of New York City's Human Rights Law prohibiting discrimination in places of public accommodation.¹⁹ New York State Club Association, Inc. (State Club) claimed the Law was facially unconstitutional and that the Law's exemption for "benevolent orders and religious corporations" violated the Equal Protection Clause.²⁰ The Court held that the Law was consti-

¹⁷ *Duarte*, 481 U.S. at 544-45. The Court held that Rotary Clubs were not considered the type of organization entitled to protection under "intimate association." *Id.* at 546. The Court reasoned that even if the Act did infringe on the members' rights, "that infringement is justified by the State's compelling interests in eliminating discrimination against women and assuring them equal access to public accommodations." *Id.* at 549. The Court also held that it would not consider the claim that the Act was unconstitutionally vague and overbroad because it was not properly presented to the state courts. *Id.*

¹⁸ 487 U.S. 1 (1988).

¹⁹ *New York State Club Ass'n*, 487 U.S. at 6. The Court first had to determine whether State Club had the standing to bring this action. *Id.* at 8. The New York State Club Association "is a nonprofit corporation, which essentially consists of a consortium of 125 other private clubs and associations in the State of New York." *Id.* at 8. The Court reasoned that State Club had standing to bring this action because the individual clubs and associations could have brought the action themselves. *Id.* at 9-10; see *International Union, United Auto., Aerospace and Agric. Implement Workers of Am. v. Brock*, 477 U.S. 274, 281 (1986) (stating that association may attain standing by representing its members); *Hunt v. Washington Apple Adver. Comm'n*, 432 U.S. 333, 343 (1977) (holding that association has standing to bring action "when: (a) its members would otherwise have standing to sue in their own right; (b) the interests it seeks to protect are germane to the organization's purpose; and (c) neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit"); *NAACP v. State of Alabama ex rel. Patterson*, 357 U.S. 449, 458-60 (1958) (holding that association had standing to bring suit on behalf of constitutional rights of its members because it and its members are synonymous and because of adverse consequences constitutional violation would have on association itself). In *Patterson*, the Court reiterated the importance of the right of privacy related to the freedom of association, and held that the order compelling the association to disclose a list of all of its members violated that right. *Patterson*, 357 U.S. at 462, 466. The Court reasoned that the state's interest in obtaining the membership list did not justify this constitutional violation. *Id.* at 464-66.

²⁰ *New York State Club Ass'n*, 487 U.S. at 7, 15. The New York Human Rights Act prohibits discrimination on the basis of "race, creed, color, national

tutional on its face and that the exemption did not violate the Equal Protection Clause.²¹ The Court reasoned that the Law, on its face, did not significantly burden State Club's expressive activity.²² The Court also stated that "legislative classi-

origin, age, gender, disability, marital status, sexual orientation or alienage " in places of public accommodation. N.Y.C. ADMIN. CODE § 8-107(2) (1986). "A club shall not be considered in its nature distinctly private if it has more than four hundred members, provides regular meal service and regularly receives payment . . . for the furtherance of trade or business." *Id.* The Law also classifies benevolent orders and religious corporations as "distinctly private." *Id.* In order to succeed in a claim challenging the facial constitutionality of a law, State Club must prove that the law is incapable of being constitutionally applied or that it is "substantially overbroad." *New York State Club Ass'n*, 487 U.S. at 111; see also *City Council of Los Angeles v. Taxpayers for Vincent*, 466 U.S. 789, 796 (1984) (stating "[t]here are two quite different ways in which a statute or ordinance may be considered invalid 'on its face'—either because it is unconstitutional in every conceivable application, or because it seeks to prohibit such a broad range of protected conduct that it is unconstitutionally 'overbroad'"); *Broadrick v. Oklahoma*, 413 U.S. 601, 613 (1973) (stating that "overbreadth doctrine . . . has been employed by the Court sparingly and only as a last resort"); *Thornhill v. Alabama*, 310 U.S. 88, 92, 101 (1940) (reversing *Thornhill's* conviction for loitering and picketing because statute was facially unconstitutional). State Club claimed the "benevolent and religious corporations" exemption violated the Equal Protection Clause because the exempted organizations were no different than the clubs and associations not exempt from the Law. *New York State Club Ass'n*, 487 U.S. at 17.

²¹ *Id.* at 14, 18. The Court stated that the application of the Law to some of the larger clubs could be held constitutional. *Id.* at 11-12. The Court reasoned that since the clubs subject to the Law contain at least 400 members, the clubs are comparable to the clubs in *Roberts v. United States Jaycees*, 486 U.S. 609 (1984), that were not entitled to private protection, and even larger than the clubs in *Duarte* that were not afforded private protection. *Id.* at 12. In concluding the Law was not "substantially overbroad," the Court stated that State Club failed to prove "that a substantial number of instances exist in which the Law cannot be applied constitutionally." *Id.* at 14. The Court also reasoned that "any overbreadth under the Law will be curable through case-by-case analysis of specific facts." *New York State Club Ass'n*, 487 U.S. at 15.

²² *Id.* at 13. The Court reasoned that application of the Law does not require the associations to change the views they wish to express, but simply restricts them from excluding individuals on the basis of race, sex, religion, etc. *Id.*; see Erika Marie Brown & Stephanie Greene, *From Private Clubs to Parades: How Accommodating Are State Laws?*, 42 N.Y.L. SCH. L. REV. 125, 129 (1998) (stating "[i]n *Roberts*, *Rotary*, and *New York State Club Association*, the Supreme Court weighed the states' compelling interest in eradicating discrimination very heavily against members' rights to association"); Lauren J. Rosenblum, Note, *Equal Access or Free Speech: The Constitutionality of Public Accommodations Laws*, 72 N.Y.U.

fications" have a rebuttable presumption of constitutionality.²³

C. Compelling Interest

In *Roberts v. United States Jaycees*,²⁴ the Supreme Court addressed the issue of whether a state's efforts to eliminate gender discrimination among its citizens was a compelling interest justifying the interference of an organization's right of expressive association.²⁵ In *Roberts*, the United States Jaycees challenged the constitutionality of the application of Minnesota's Human Rights Act, which required the admission of women to its local chapters in Minnesota.²⁶ The Court held

L. REV. 1243, 1281 n.130 (1997) (stating that Court's "assessment of the likely impact of the statute indicates that it agreed with the city council that any restriction wrought by the Human Rights Law on the club members' associational rights was likely to be de minimis").

²³ *New York State Club Ass'n*, 487 U.S. at 17. The Court reasoned that "New York State law indicates that benevolent orders and religious corporations are unique and thus that a rational basis exists for their exemption." *Id.* at 16. The Court held State Club failed to carry its burden of proving that there was no reasonable basis for the "legislative classifications." *Id.* at 17; see *United States v. Carolene Prods. Co.*, 304 U.S. 144, 152 (1938) (stating legislative classifications are presumed constitutional unless proven otherwise); *New York ex rel. Bryant v. Zimmerman*, 278 U.S. 63, 75 (1928) (holding differences in classes of associations justified legislative classification); Michelle L. Carusone, Comment, *Dale v. Boy Scouts of America and Monmouth Council: New Jersey's Attempt to Define Places of Public Accommodation and Remedy the "Cancer of Discrimination,"* 49 CATH. U. L. REV. 823, 869 (2000) (stating private clubs and religious organizations are frequently exempted).

²⁴ 468 U.S. 609 (1984).

²⁵ *Roberts*, 468 U.S. at 612. The Court also addressed the issue of whether the application of Minnesota's Human Rights Act was unconstitutionally vague and overbroad. *Id.* at 616.

²⁶ *Id.* at 612. Jaycees restricted its regular membership to men, ages 18 through 25. *Id.* at 613. Women were allowed associate membership, but were unable to vote, hold office, or participate in particular leadership activities. *Id.* Two local Minnesota chapters began admitting women as regular members between 1974 and 1975. *Id.* at 614. After imposing numerous sanctions on the two chapters, the national organization notified them that their charters could be revoked. *Roberts*, 468 U.S. at 614. Members of both chapters filed discrimination charges against the national organization, claiming it had violated the Minnesota Human Rights Act. *Id.* After the Minnesota Human Rights Department hearing examiner concluded that the Jaycees is a "place of public accommodation" under

that Minnesota had a compelling interest in eliminating gender discrimination, and that the Human Rights Act was not unconstitutionally vague or overbroad.²⁷ The Court reasoned that the right of expressive association was not absolute.²⁸ The State had employed the least restrictive means available in applying the Act, and the impact on the organization was not any greater than necessary for the State to achieve its goal.²⁹

the Act and that the national organization had violated the Act, the United States Jaycees filed a complaint. *Id.* at 615-16. The Minnesota Human Rights Act prohibits discrimination on the basis of gender, among other things, in places of public accommodation. MINN. STAT. ANN. § 363.03 (West 1982). *See* *Cross v. Midtown Club, Inc.*, 365 A.2d 1227, 1230 (Conn. 1976) (holding luncheon club's exclusion of women as members or guests was neither necessary nor convenient to purpose for which club was organized); Margaret Graham Tebo, *Massachusetts Court Takes Shot at Private Country Club for Gender Discrimination*, 86-FEB. A.B.A. J. 26, 26 (2000) (describing limited membership of women to golf clubs).

²⁷ *Roberts*, 468 U.S. at 626-31. The Court separately considered "the effect of applying the Minnesota statute to the Jaycees on . . . its members' freedom of intimate association and their freedom of expressive association." *Id.* at 618. The Court held that the Jaycees' organization did not have the necessary relationships that would entitle it to protection under the right of "intimate association." *Id.* at 621. *See* Darren Lenard Hutchinson, *Accommodating Outness: Hurley, Free Speech, and Gay and Lesbian Equality*, 1 U. PA. J. CONST. L. 85, 95 (1998) (stating "[t]he Court easily disposed of the Jaycees' intimate association defense, noting the organization's large size and unselective membership criteria"). However, the Court held that the Jaycees was entitled to freedom of "expressive association." *Roberts*, 468 U.S. at 622-23. In determining the Act was not unconstitutionally vague, the Court considered the "specific and objective criteria" applied by the Minnesota Supreme Court in its decision that the Jaycees was subject to the Act. *Id.* at 629. In holding the Act was not unconstitutionally overbroad, the Court reasoned the Act "does not create an unacceptable risk of application to a substantial amount of protected conduct." *Id.* at 631; *see* Shannon L. Doering, *Treading on the Constitution to Get a Foot in the Clubhouse Door*, 78 NEB. L. REV. 644, 665 (1999) (describing how compelling interest analysis balances right of association against state's interest).

²⁸ *Roberts*, 468 U.S. at 623. The Court stated that "[i]nfringements on that right may be justified by regulations adopted to serve compelling state interests unrelated to the suppression of ideas, that cannot be achieved through means significantly less restrictive of associational freedoms." *Id.*; *see* *Brown v. Socialist Workers '74 Campaign Comm.*, 459 U.S. 87, 91-92 (1982) (explaining infringement on political freedom can be justified by compelling state interest); *Buckley v. Valeo*, 424 U.S. 1, 25 (1976) (explaining infringement on right of expressive association can be justified by compelling state interests achieved by least restrictive means available).

²⁹ *Roberts*, 468 U.S. at 610. The Court stated that "the Jaycees has failed to

III. BOY SCOUTS OF AMERICA V. DALE

A. *Opinion of the Court*

In *Boy Scouts of America v. Dale*,³⁰ the United States Supreme Court held that where the presence of an avowed homosexual significantly affects the Boy Scouts' ability to express its views, the application of New Jersey's public accommodations law requiring the Boy Scouts to include that person violates the Boy Scouts' First Amendment right of expressive association.³¹

The Court first addressed the issue of whether the Boy Scouts engaged in "expressive association," thereby entitling the group to protection under the First Amendment's expressive associational right.³² The Court concluded the mission of the Boy Scouts is "to instill values in young people," and that the adult leaders instilled these values "both expressly and by example."³³ The Court concluded the Boy Scouts engaged in "expressive association" which entitled it to protection under the First Amendment.³⁴

The Court next considered whether the presence of Dale, as assistant scoutmaster, would significantly burden the Boy

demonstrate that the Act imposes any serious burdens on the male members' freedom of expressive association." *Id.* at 626; see Karen L. Dayton, *Dale v. Boy Scouts of America: New Jersey's Law Against Discrimination Weighs the Balance Between the First Amendment and the State's Compelling Interest in Eradicating Discrimination*, 16 GA. ST. U. L. REV. 387, 393-94 (1999) (describing how "[t]he Court weighed the Jaycee's freedom of expressive association against Minnesota's compelling interest in ending discrimination against women").

³⁰ 120 S. Ct. 2446 (2000).

³¹ *Dale*, 120 S. Ct. at 2457. The Court held that the State's interest in eliminating discrimination did not justify the infringement on the Boy Scouts' right of "expressive association." *Id.*

³² *Id.* at 2451. The Court stated that "a group must engage in some form of expression, whether it be public or private," in order be protected by the First Amendment. *Id.*

³³ *Id.* at 2452. The values the Boy Scouts sought to instill could be found in the "Scout Oath" and the "Scout Law." *Id.* These values are instilled in young people during the time spent with the members' adult leaders. *Id.*

³⁴ *Id.* The Court concluded instilling a system of values in young people was a form of expressive activity. *Id.*

Scouts' ability to express its views.³⁵ The Court gave deference to the Boy Scouts' assertion that homosexuality was inconsistent with the values it sought to instill in young people.³⁶ The Court concluded that it also must give deference to the Boy Scouts' assertion of what would significantly burden its ability to express its views.³⁷

Finally, the Court considered whether the application of New Jersey's public accommodations law forcing the inclusion of Dale would infringe on the Boy Scouts' right of expressive association.³⁸ The Court held that since New Jersey's interest in eliminating discrimination was not compelling, the infringement on the Boy Scouts' right of expressive association was not justified.³⁹ Therefore, the Court held the application of New Jersey's public accommodations law would violate the Boy Scouts' First Amendment rights.⁴⁰

³⁵ *Id.* In order to do this, the Court first had to determine the Boy Scouts' position on homosexuality. *Id.* The Boy Scouts stressed the terms "morally straight" and "clean" in its assertion that homosexuality was contrary to the values found in the "Scout Oath" and the "Scout Law." *Id.*

³⁶ *Dale*, 120 S. Ct. at 2453. The Court found that, although different meanings could be attributed to these terms, "it is not the role of the courts to reject a group's expressed values because they disagree with those values or find them internally inconsistent." *Id.* at 2452-53 (citing *Democratic Party of United States v. Wisconsin ex rel. La Follette*, 450 U.S. 107, 124 (1981)).

³⁷ *Id.* at 2453. Since Dale was an avowed homosexual and gay rights activist, his presence "would, at the very least, force the organization to send a message . . . that the Boy Scouts accepts homosexual conduct as a legitimate form of behavior." *Id.* at 2454. The Court's holding on this issue differed from the New Jersey Supreme Court in three major aspects. *Id.* at 2454-55. First, the Boy Scouts does not have to associate for the "purpose" of transmitting a particular message in order to be protected by the First Amendment. *Id.* at 2454. Second, First Amendment protection is not barred by the fact that the Boy Scouts discouraged adult leaders from expressing their views on sexual issues. *Dale*, 120 S. Ct. at 2454-55. Finally, there does not have to be complete agreement among members in order to engage in expressive activity. *Id.* at 2455.

³⁸ *Id.* The Court applied the traditional First Amendment analysis applied in *Hurley v. Irish-American Gay, Lesbian and Bisexual Group of Boston*. *Id.* at 2457.

³⁹ *Id.* The Court stated "public or judicial disapproval of a tenet of an organization's expression does not justify the State's effort to compel the organization to accept members where such acceptance would derogate from the organization's expressive message." *Id.* at 2458.

⁴⁰ *Id.* at 2457. The Court stated "New Jersey's public accommodations law directly and immediately affects associational rights . . . that enjoy First Amend-

B. Justice Stevens' Dissenting Opinion

In his dissent, Justice Stevens argued the "courageous State" of New Jersey was not given the respect it deserved for its bold move against discrimination.⁴¹ The dissent argued the Boy Scouts had failed to state publicly an unequivocal position on homosexuality.⁴² The dissent also stated that the application of the New Jersey public accommodations law would not significantly burden the Boy Scouts' ability to express its views.⁴³ Finally, the dissent stated the Court should

ment protection." *Id.*

⁴¹ *Dale*, 120 S. Ct. at 2459 (Stevens, J., dissenting). The dissent placed significant importance on Justice Brandeis' experimentation comment in *New State Ice Company v. Liebmann*. *Id.* (Stevens, J., dissenting). The dissent also noted that New Jersey's public accommodation statute had a broader reach than most public accommodation statutes. *Id.* (Stevens, J., dissenting).

⁴² *Id.* at 2460 (Stevens, J., dissenting). The dissent argued the terms "morally straight" and "clean" have no meaning in reference to homosexuality. *Id.* at 2461 (Stevens, J., dissenting). The dissent also reiterated the fact that adult leaders are discouraged from expressing their views on sexual issues, and the youth are discouraged from asking the adult leaders questions regarding sexual issues. *Id.* at 2462 (Stevens, J., dissenting). The dissent also noted that the Boy Scouts' position found in the 1978 statement was never made public. *Id.* at 2463 (Stevens, J., dissenting). The dissent argued that the four other policy statements relied on by the majority were irrelevant because they were issued after Dale's membership was revoked. *Dale*, 120 S. Ct. at 2464 (Stevens, J., dissenting). The dissent argued there was no support for the Boy Scouts' assertion that homosexuality was inconsistent with the values it seeks to instill. *Id.* at 2465 (Stevens, J., dissenting). The dissent concluded that the Boy Scouts should not be able to succeed in a discrimination suit without having a clear, public position on homosexuality. *Id.* (Stevens, J., dissenting).

⁴³ *Id.* at 2459-60 (Stevens, J., dissenting) (citing *Roberts v. United States Jaycees*, 486 U.S. 609, 622, 626-27 (1984)). The dissent argued that it was impossible for the presence of a homosexual to significantly burden the Boy Scouts' ability to express its views if the Boy Scouts' position on homosexuality was unclear. *Id.* at 2470 (Stevens, J., dissenting). The dissent also argued that the Court should not give deference to the Boy Scouts' assertion of its views on homosexuality and what would significantly burden those views, but should conduct an independent investigation. *Id.* at 2471 (Stevens, J., dissenting). The dissent pointed out that the Boy Scouts had not made a claim that Dale has expressed homosexual views to the members of his troop; therefore, his revocation was merely based on an unwarranted assumption. *Id.* at 2472 (Stevens, J., dissenting). Finally, the dissent distinguished this case from *Hurley*, and argued that a different level of scrutiny should have applied on the facts presented. *Id.* at 2475-76 (Stevens, J., dissenting).

factor into its constitutional analysis the fact that society's opinion of homosexuals has drastically changed.⁴⁴

C. Justice Souter's Dissenting Opinion

Justice Souter joined in Justice Stevens' dissent, but disagreed with Justice Stevens' opinion that the change in society's view of homosexuality should have any bearing on the Court's constitutional analysis.⁴⁵

IV. DISCUSSION

In *Boy Scouts of America v. Dale*, the Court applied the traditional First Amendment analysis it has applied in similar discrimination cases.⁴⁶ The Court reiterated the fact that an organization is entitled to protection under the First Amendment when it engages in any form of expressive activity.⁴⁷ The Court gave deference to the Boy Scouts' assertions of what would significantly interfere with its expressive activity.⁴⁸

Because of the deference afforded by the Court, it will be easier for clubs and organizations to prevail in discrimination suits against them.⁴⁹ The organization will merely have to

⁴⁴ *Id.* at 2477-78 (Stevens, J., dissenting). The dissent stated the Court should consider the recent changes in society's opinion of homosexuality, rather than adhere to the stereotypes attributed to homosexuals in the past. *Id.*

⁴⁵ *Id.* at 2478-79 (Souter, J., dissenting). Justice Souter stated that "The right of expressive association does not, of course, turn on the popularity of the views advanced by a group that claims protection." *Id.* at 2479 (Souter, J., dissenting).

⁴⁶ See *supra* notes 17, 22, 27, 29, 38 and accompanying text. The Court applied a balancing test, weighing the State's interest of eliminating discrimination against the Boy Scouts' right of expressive association in concluding that the infringement on the Boy Scouts' rights was not justified by a compelling interest. See *supra* notes 27, 31, 39 and accompanying text.

⁴⁷ See *supra* notes 12, 34 and accompanying text. The Court rejected the lower court's view that a group had to associate for the sole purpose of communicating a certain message, or that there had to be complete agreement on every issue in order to warrant protection. See *supra* note 37 and accompanying text.

⁴⁸ See *supra* notes 36-37 and accompanying text. After the Court's rejection of the lower court's approach, it is far less difficult for a group to be considered engaged in a form of expressive activity. See *supra* notes 34, 37 and accompanying text.

⁴⁹ See *supra* note 36 and accompanying text. The club or organization will no

state the views it wishes to express, and that the unwanted individual's presence would significantly burden its ability to express those views.⁵⁰ The Court has emphasized it is not the role of the courts to judge the views an organization wishes to express.⁵¹ The Court's role is simply to insure that an organization's freedom of expressive association is not infringed upon by the State.⁵² The Court's holding in this case was not designed to discourage states in their efforts to end discrimination, but rather to place a renewed importance on the freedom of expressive association.⁵³

V. CONCLUSION

Boy Scouts of America v. Dale resolved the issue of whether the forced inclusion of an avowed homosexual would violate the Boy Scouts' First Amendment right of expressive association. The Court applied the traditional freedom of association analysis and concluded Dale's presence would significantly burden the Boy Scouts' ability to express its views. *Dale* extends the expressive freedom of clubs and organizations by giving deference to their assertions of what their views are and what would significantly burden those views. The right of expressive association is not absolute, and can be overcome by a compelling state interest. In this case, however, the infringement on the Boy Scouts' right of expressive association was

longer have to prove the views they wish to express or how the individual would be a significant burden. See *supra* notes 36-37 and accompanying text.

⁵⁰ See *supra* notes 36-37 and accompanying text. After *Dale*, courts may accept a group's assertion without conducting an independent analysis of their expressive activity. See *supra* notes 17, 22, 37 and accompanying text.

⁵¹ See *supra* notes 11, 36, 39, 45 and accompanying text. However, Justice Stevens' dissent stated society's current opinion of homosexuality should be considered in the Court's constitutional analysis. See *supra* note 44 and accompanying text.

⁵² See *supra* notes 38-40 and accompanying text. Infringement on an organization's freedom of "expressive association" can be justified only by a compelling state interest. See *supra* notes 21-22, 25, 27-29 and accompanying text.

⁵³ See *supra* notes 11-12, 31, 34, 36, 40 and accompanying text. Justice Stevens' dissent argued that New Jersey should have been given more respect for its far-reaching public accommodations statute and its bold move against discrimination. See *supra* notes 16, 41 and accompanying text.

not justified by the State's effort to eliminate discrimination.

Kelly Carter

**CONSTITUTIONAL LAW—FIRST AMENDMENT—GOVERNMENT
MUST DEMONSTRATE THAT THERE IS NOT A LESS
RESTRICTIVE ALTERNATIVE BEFORE A CONTENT-BASED
RESTRICTION OF PROTECTED SPEECH CAN SURVIVE STRICT
SCRUTINY**

I. FACTS

Section 505 of the Communications Decency Act of 1996 (CDA) required cable television operators, who provide channels “primarily dedicated to sexually-oriented programming,” to fully scramble or block those particular channels, or to “time channel.”¹ The purpose of § 505 was to prevent children from hearing or seeing images as a result of signal bleed.² As a result of the statute and in an attempt to comply with § 505, the majority of cable operators employed “time channeling.”³ Playboy Entertainment filed suit in the United States District Court for the District of Delaware, claiming the statute’s content-based restriction on speech violated the First Amendment.⁴

¹ 47 U.S.C. § 561(a) (Supp. III 1994). Time channeling requires the cable operator to restrict the hours in which the channels can be viewed to hours when children are unlikely to be watching. *Id.* The regulation designated between 10 p.m. and 6 a.m. as the hours that children are unlikely to be watching. *Id.*

² *United States v. Playboy Entertainment Group, Inc.*, 120 S. Ct. 1878, 1883 (2000). Although scrambling was already in use before the enactment of the statute, it is not perfect. *Id.* Portions of the scrambled program may still be heard or seen at times as a result of signal bleed. *Id.*

³ *Id.* The adoption of time channeling by the majority of cable operators prevented all viewers in that area from viewing the programming for two-thirds of the day, whether they wanted to or not. *Id.* Time channeling placed a significant restriction on communication given that 30% to 50% of all adult programming is viewed before 10 p.m. *Id.* at 1884.

⁴ *Playboy Entertainment Group, Inc. v. United States*, 30 F. Supp. 2d 702, 713-14 (D. Del. 1998). The First Amendment states: “Congress shall make no law . . . abridging the freedom of speech.” U.S. CONST. amend. I. Playboy Entertainment also claimed the statute violated the Fifth Amendment and that the statute

The United States District Court for the District of Delaware held § 505 violated the First Amendment and enjoined its enforcement.⁵ The United States filed a direct appeal to the United States Supreme Court.⁶ The United States Supreme Court granted certiorari and held: affirmed.⁷ The Court held that where a regulation imposes a content-based restriction on protected speech to protect children from encountering indecent speech in the home, the regulation will not be upheld if there is a less restrictive alternative to further the government's interests.⁸

II. RELATED LAW

Content-based regulations receive strict scrutiny because they directly regulate the substance of speech.⁹ When review-

was unconstitutionally vague. *Playboy Entertainment*, 30 F. Supp. 2d at 713-14. Playboy Entertainment sought a declaratory judgment that § 505 was unconstitutional and injunctive relief against its enforcement. *Id.* Playboy Entertainment prepares programs for adult television in which almost all of the programs contain sexually explicit material as defined by the statute. *Playboy Entertainment*, 120 S. Ct. at 1883.

⁵ *Id.* at 1884-85. The district court concluded § 505 was a content-based restriction on speech, and after applying strict scrutiny, found that although the interests of the statute were compelling, those interests could be furthered in a less restrictive manner. *Playboy Entertainment*, 30 F. Supp. 2d at 714-20. Because § 505 violated the First Amendment, the court did not address Playboy's other contentions. *Id.* at 714. The district court found § 504 of the Telecommunications Act of 1996 would be less restrictive but just as effective in furthering the interests of the statute if supplemented with adequate notice to the subscriber. *Id.* at 718-20. Section 504 requires a cable operator "upon request by the subscriber . . . to fully scramble or otherwise fully block" any channel the subscriber does not wish to receive. 47 U.S.C. § 560 (Supp. III 1994). The district court required Playboy to ensure that the cable operators provide adequate notice of § 504 to its subscribers. *Playboy Entertainment*, 30 F. Supp. 2d at 719-20.

⁶ *Playboy Entertainment*, 120 S. Ct. at 1885. Title 47 U.S.C. § 561 allowed for an appeal directly to the United States Supreme Court after judgment in district court. *Id.*

⁷ *Id.* Generally, the right of expression prevails over a content-based restriction of speech. *Id.* at 1886.

⁸ *Id.* For a content-based restriction on speech to be upheld, the government must satisfy the strict scrutiny standard. *Id.*

⁹ Megan G. Rosenberger, Note, *De Facto Censorship: Adult Content Video Scrambling and the First Amendment*, 8 COMMLAW CONSPECTUS 99, 105 (2000). The Court has determined that there are two requirements the government must

ing content-based regulations of speech, the Court uses a contextual rather than rule-bound analysis.¹⁰ Not only does the Court carefully consider the context, but because communication technology is always changing, the Court applies a balancing test.¹¹

A. Radio Broadcast

In *Federal Communications Commission v. Pacifica Foundation*,¹² the Supreme Court addressed the issue of whether the First Amendment allows the government to restrict the public broadcast of indecent but not obscene language.¹³ In *Pacifica Foundation*, the broadcasters claimed the ruling by the Federal Communications Commission, that the station's broadcast was indecent and prohibited by statute, violated their First Amendment right to free speech.¹⁴ The Court re-

meet in order to validate a content-based regulation. *Id.* First, the government must have a compelling interest to protect, and second, the regulation must be the least restrictive means available to protect that interest. *Id.* But see Ed Foley, Comment, *The First Amendment as Shield and Sword: Content Control of Peg Access Cable Television*, 27 CAP. U. L. REV. 961, 985 (1999) (advocating that neither government nor courts should engage in content control).

¹⁰ Jonathan Weinberg, *Cable TV, Indecency and the Court*, 21 COLUM.-VLA J.L. & ARTS 95, 128 (1997). The Court does not apply one set of rules to every medium of communication but rather looks at each separately. *Id.*

¹¹ Mara Andre Glaser, Casenote, *Cable Television's New Standard Is No Standard: An Analysis of the Supreme Court's Balancing Act in Denver Area Educational Telecommunications Consortium v. FCC*, 30 CREIGHTON L. REV. 1461, 1463 (1997). The Court weighs the benefits of the regulation and the severity of the problem to be addressed against the restrictions it imposes to determine if a regulation is narrowly tailored and the least restrictive. *Id.*

¹² 438 U.S. 726 (1978).

¹³ *Pacifica Foundation*, 438 U.S. at 744. The Court noted that if the government has any such power, this is a proper occasion for its use. *Id.*

¹⁴ *Id.* at 742. At two o'clock in the afternoon, a New York radio station owned by Pacifica broadcasted a prerecorded twelve-minute monologue by George Carlin entitled "Filthy Words." *Id.* at 729. In response to complaints, the Commission concluded the monologue contained words which "depicted sexual and excretory activities in a patently offensive manner" and was broadcast at a time children were likely to be in the audience. *Id.* at 732. The Commission held the language in the broadcast was indecent and prohibited by 18 U.S.C. § 1464. *Id.* In clarifying its order, the FCC explained that it did not intend to place an outright ban on this type of broadcast, but only intended to channel it to times when

jected their claim, and held the Commission's order did not violate the broadcasters' First Amendment rights.¹⁵ The Court explained that not all content-based regulation of speech is invalid because both content and context are critical elements in the First Amendment analysis.¹⁶ The Court determined special treatment of indecent broadcasting is justified given the context in which this broadcast was made.¹⁷ The Court recognized that of all forms of communication, broadcasting receives the most limited First Amendment protection.¹⁸

children were not likely to be exposed to it. *Pacifica Foundation*, 438 U.S. at 732-33. See generally 16A AM. JUR. 2D *Constitutional Law* § 524 (1998) (discussing importance of time indecent speech is broadcast).

¹⁵ *Pacifica Foundation*, 438 U.S. at 750-51. Besides the constitutional question, the Court addressed two statutory questions. *Id.* at 735. The first was whether the Commission's action was forbidden censorship under 47 U.S.C. § 326. *Id.* The Court determined that it was not, and that the Commission has the authority under § 326 to sanction broadcasters who broadcast obscene, indecent, or profane broadcasting. *Id.* at 738. The second statutory question was whether the language of the monologue was indecent under 18 U.S.C. § 1464. *Id.* at 738-39. The Court concluded the language was in fact indecent. *Pacifica Foundation*, 438 U.S. at 741.

¹⁶ *Id.* at 745. The constitutional protection given to such patently offensive language is not the same in every circumstance; therefore, the context must be examined. *Id.* at 747-48; see *Southeastern Promotions, Ltd. v. Conrad*, 420 U.S. 546, 557 (1975) (declaring that each medium of expression must be assessed according to standards suited to it because each presents its own problems); *Joseph Burstyn, Inc. v. Wilson*, 343 U.S. 495, 502-03 (1952) (recognizing each medium of expression presents special First Amendment problems); *Schenck v. United States*, 249 U.S. 47, 52 (1919) (stating that in every case question is whether words in that particular circumstance are of such nature that would create danger and evils that Congress has right to prevent); see, e.g., *Miller v. California*, 413 U.S. 15, 19-24 (1973) (allowing obscenity to be wholly prohibited); *Chaplinsky v. New Hampshire*, 315 U.S. 568, 572 (1942) (approving government's right to forbid speech calculated to start fights). See generally Christopher M. Schultz, Note, *Content-Based Restrictions on Free Expression: Reevaluating the High Versus Low Value Speech Distinction*, 41 ARIZ. L. REV. 573, 599 (1999) (advocating that context is crucial in determining protection speech receives under First Amendment).

¹⁷ *Pacifica Foundation*, 438 U.S. at 747-50. The Court viewed the content of the broadcast as "vulgar, offensive, and shocking," and noted that the words of the broadcast offend for the same reasons that obscenity, which receives no First Amendment protection, offends. *Id.* at 745-47. Regarding the context, the broadcast was made over the radio at a time that made it likely children would hear the broadcast. See *supra* note 14 and accompanying text.

¹⁸ *Pacifica Foundation*, 438 U.S. at 748; see, e.g., *Red Lion Broad. Co. v. FCC*, 395 U.S. 367, 396 (1969) (requiring broadcasters to give free time to those they

B. Telephone Communication

In *Sable Communications, Inc. v. Federal Communications Commission*,¹⁹ the Supreme Court addressed the constitutionality of an amendment to the Communications Act of 1934 imposing a blanket prohibition on obscene as well as indecent interstate telephone messages.²⁰ Sable Communications, who offers sexually-oriented prerecorded telephone messages, claimed the statute's ban violated the First and Fourteenth Amendments.²¹ The Supreme Court held the prohibition of "obscene" telephone messages constitutional; however, the ban on "indecent" telephone messages violated the First Amendment and thus failed to survive constitutional scrutiny.²² The Court explained that although sexual expression, which is indecent but not obscene, receives First Amendment protection, the government can regulate it to further a compelling interest if the least restrictive means is employed.²³ The

have criticized); cf. *Miami Herald Publ'g Co. v. Tornillo*, 418 U.S. 241, 258 (1974) (holding newspaper publishers are not required to print replies of those they criticize). The Court gave two reasons to support the different treatment of broadcasters. *Pacifica Foundation*, 438 U.S. at 748. First, the broadcast media has a unique presence in society. *Id.* The airwaves confront citizens not only in public, but also in their home, and prior warnings cannot completely protect citizens. *Id.* Second, because broadcasting is uniquely accessible to children unlike other forms of offensive expression, the government has an interest in protecting the children. *Id.* at 749; see *Ginsberg v. New York*, 390 U.S. 629, 640 (1968) (holding that regulation of otherwise protected speech is justified by government's interest in "well being of its youth"); see also *Erzonznik v. Jacksonville*, 422 U.S. 205, 212 (1975) (recognizing society's right to "adopt more stringent controls on communicative materials available to youths than on those available to adults").

¹⁹ 492 U.S. 115 (1989).

²⁰ *Sable Communications*, 492 U.S. at 117-18. The amendment banned these messages from being directed to any person regardless of their age and made it illegal for adults as well as minors (children) to have access to these types of messages. *Id.* at 122-23.

²¹ *Id.* at 117-18. Sable's service, popularly known as "dial-a-porn," was offered through the Pacific Bell telephone network. *Id.* Sable sought declaratory judgment that the statute was unconstitutional and injunctive relief from its enforcement. *Id.* at 118.

²² *Id.* at 124-26. It has been established by previous cases that obscene speech receives no First Amendment protection. *Id.* at 124; see *Paris Adult Theatre I v. Slaton*, 413 U.S. 49, 69 (1973) (approving regulation of obscene material in adult theaters from which minors were excluded).

²³ *Sable Communications*, 492 U.S. at 126. The Court pointed out that it is

Court recognized that there is a compelling interest in protecting the physical as well as the psychological well being of minors.²⁴ However, the Court found the means employed were not narrowly tailored because the denial of adult access far exceeded that which is necessary to prevent minors from having access to the indecent telephone messages.²⁵ The Court reiterated that "the government may not reduce the adult population . . . to . . . only what is fit for children."²⁶

C. Internet Communication

In *Reno v. American Civil Liberties Union*,²⁷ the issue was the constitutionality of two statutory provisions of the Communications Decency Act (CDA) of 1996 aimed at protecting minors from indecent and patently offensive communication on the Internet.²⁸ The American Civil Liberties Union

not enough to show that there is a compelling interest, but the means must also be narrowly tailored. *Id.*

²⁴ *Id.*; see *New York v. Ferber*, 458 U.S. 747, 756-57 (1982) (extending government's interest in protecting children to prohibiting distribution of materials which depict sexual performance by children).

²⁵ *Sable Communications*, 492 U.S. at 131; see Kevin W. Saunders, *Electronic Indecency: Protecting Children in the Wake of the Cable and Internet Cases*, 46 *DRAKE L. REV.* 1, 29 (1997) (concluding that in efforts to protect children, restrictions placed on adult access to indecent material cannot be greater than necessary). The Court noted that the use of credit cards, access codes, and scrambling are a more feasible and effective way of achieving the government's interest rather than an outright ban. *Sable Communications*, 492 U.S. at 128. The Court distinguished this case from *Pacifica Foundation* in two ways. *Id.* at 127. First, *Pacifica Foundation* did not involve a total ban as this case did, but only channeled the speech to times when children were not likely to be listening. *Id.* Second, the Court noted that the medium of the telephone requires the individual to take affirmative steps to receive the indecent message unlike broadcasting, mailings, or public displays where the individual can be exposed to indecent speech by surprise. *Id.* at 128.

²⁶ *Id.* at 128. The amendment limited the content of adult telephone conversations to that which is suitable for children. *Id.* at 131; see *Butler v. Michigan*, 352 U.S. 380, 383-84 (1957) (finding law which limited general public materials to that which is suitable for children not narrowly tailored and in violation of adults' free speech rights).

²⁷ 521 U.S. 844 (1997).

²⁸ *Reno*, 521 U.S. at 849. The first of the provisions was 47 U.S.C. § 223(a) which made it illegal to knowingly transmit obscene or indecent material to any-

claimed the statutes were overly broad and violated the First Amendment.²⁹ Given the breadth of this content-based restriction of speech, the Court found the statutes not narrowly tailored to achieve the government's interest.³⁰ The Court explained that because of the vague and overly broad scope of the statutes, some speakers whose speech deserves constitutional protection will be suppressed, and this suppression cannot be justified, provided there is a less restrictive alternative.³¹

one under 18. *Id.* at 859. The second provision, § 223(d), prohibited knowingly sending or displaying patently offensive messages where someone under 18 could have access to them. *Id.*

²⁹ *Id.* at 864. The broad prohibitions of the CDA were not limited to certain times, nor were they subject to evaluation by any agency. *Id.* at 867.

³⁰ *Id.* at 879-83. The government did not meet its burden to explain why a less restrictive alternative would not be as effective. *Id.*; see *Greater New Orleans Broad. Ass'n v. United States*, 527 U.S. 173, 183 (1999) (requiring government to prove constitutionality of its restriction of speech); *R.A.V. v. St. Paul*, 505 U.S. 377, 382 (1992) (recognizing that content-based regulations are presumed to be invalid); *Board of Trustees of State Univ. of New York v. Fox*, 492 U.S. 469, 480 (1989) (holding government must justify its restrictions); see also *Edenfield v. Fane*, 507 U.S. 761, 770-71 (1993) (stating that government seeking to restrict speech must demonstrate real problem, and that its restriction will alleviate it to material degree); *Tinker v. Des Moines Indep. Community Sch. Dist.*, 393 U.S. 503, 509 (1969) (holding that in order for government to restrict particular type of speech, it must show that it was done to achieve more than mere desire to avoid discomfort and unpleasantness of unpopular views). The Court found that the government's interest in protecting minors was not strong enough to justify these broad statutes. *Reno*, 521 U.S. at 878. However, the Court severed the term "or indecent" from § 223(a) and left the remaining portion of § 223(a) standing. *Id.* at 883.

³¹ *Id.* at 870-74. Not only was the coverage of the CDA unprecedented, the prohibitions of it were open ended and could include anything. *Id.* at 877; see Rebecca J. Dessoff, Note, *Salvaging the Communications Decency Act in the Wake of ACLU v. Reno and Shea v. Reno*, 45 CLEV. ST. L. REV. 271, 298 (1997) (concluding CDA can be rewritten more narrowly); Debra M. Keiser, Note, *Regulating the Internet: A Critique of Reno v. ACLU*, 62 ALB. L. REV. 769, 800 (1998) (concluding that regulating Internet is necessary but CDA should be redrafted with more specific guidelines and definitions). The Court recognized that encountering indecent material on the Internet requires some affirmative steps unlike radio broadcast; therefore, the risk of accessing it accidentally is remote and does not justify the restrictions imposed by the statute. *Reno*, 521 U.S. at 854; see Stephen C. Jacques, Comment, *Reno v. ACLU: Insulating the Internet, the First Amendment, and the Marketplace of Ideas*, 46 AM. U. L. REV. 1945, 1961 (1997) (discussing Court's application of medium-specific analysis to different forms of communication based on their unique characteristics). In order to deny minors access

D. Television Broadcast

In *Denver Area Educational Telecommunications Consortium, Inc. v. Federal Communications Commission*,³² the Court addressed the issue of whether three provisions, which sought to regulate the broadcasting of "patently offensive" sex-related material on cable television, violated the First Amendment.³³ Denver Area claimed these provisions imposed content-based restrictions on speech and were not narrowly tailored and, therefore, violated their freedom of speech.³⁴ The Court found § 10(a) constitutional, but held § 10(b) and § 10(c) violated the First Amendment.³⁵ The Court explained that

to indecent speech, the CDA suppressed speech that adults have the constitutional right to receive. *Reno*, 521 U.S. at 874. The Court recognized the protection of children is a compelling government interest; however, it also recognized that "sexual expression which is indecent but not obscene" is protected by the First Amendment. *Id.* at 874-75; see *Carey v. Population Servs. Int'l*, 431 U.S. 678, 701 (1977) (recognizing that where obscenity is not involved, Court has consistently held that suppression of indecent speech is not justified because it may be offensive to some). The Court found that the evidence indicated an effective method for parents to protect their children from indecent and offensive material on the Internet will soon be available. *Reno*, 521 U.S. at 855; cf. Kelly M. Doherty, *WWW Obscenity.Com: An Analysis of Obscenity and Indecency Regulation on the Internet "Uncle Sam Out of My Homepage!"*, 32 AKRON L. REV. 259, 260 (1999) (concluding that protecting children from indecent material on Internet is responsibility of parents, and, therefore, Internet regulation should begin at home).

³² 518 U.S. 727 (1996).

³³ *Denver Area*, 518 U.S. at 732. The three provisions (part of the Cable Television Consumer Protection and Competition Act of 1992) apply to programs broadcast over cable on leased and public, educational, or governmental access channels. *Id.* Section 10(a) and § 10(c) allowed a cable system operator to prohibit the broadcasting of "programming" that "the operator reasonably believes describes or depicts sexual or excretory activities or organs in a patently offensive manner." *Id.* Section 10(a) applied to leased access channels while § 10(c) applied to public, educational, or governmental channels. *Id.* at 733. Section 10(b) required the cable system operator to segregate certain "patently offensive" programming, place it on a single channel, and to block that channel from the access of the viewer unless the viewer request access. *Id.*

³⁴ *Id.* at 739. Denver Area appealed to the Supreme Court after the Court of Appeals, sitting en banc, found all three provisions consistent with the First Amendment. *Id.* at 737.

³⁵ *Id.* at 733. Section 10(a) permitted only the operator to decide whether to broadcast the programs over leased access channels. *Id.* Even in the area of broadcasting, the First Amendment does not ordinarily regulate private citizens'

§ 10(a) restored the editorial control to cable operators they once had and permitted only cable operators to restrict speech.³⁶ However, because § 10(b) required the operators to restrict speech, the Court weighed the benefits of the statute against the restrictions it imposed, and found the section overly restrictive and not narrowly tailored.³⁷ Although § 10(c) was similar to § 10(a), it did not restore any editorial rights to the operators, nor was the government able to satisfy strict scrutiny with regard to this section.³⁸

decisions to permit or restrict speech. *Id.* at 737; see *Turner Broad. Sys., Inc. v. Federal Communications Comm'n*, 512 U.S. 622, 636 (1994) (holding that editorial function is itself part of free speech); see, e.g., *Consolidated Edison Co. of New York v. Public Serv. Comm'n of New York*, 447 U.S. 530, 544 (1980) (invalidating ban on political speech by public utility using its billing envelopes as broadcast medium); *Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n of New York*, 447 U.S. 557, 571 (1980) (striking restriction on public utility's promotional advertising); *Columbia Broad. Sys., Inc. v. Democratic Nat'l Comm.*, 412 U.S. 94, 130-32 (1973) (striking restrictions on broadcaster's ability to refuse to carry political advertising). The two provisions in violation were § 10(b) which required the operator to segregate and block programming and § 10(c) which was the same as § 10(a) but applicable to public, educational, or governmental channels. *Denver Area*, 518 U.S. at 733.

³⁶ *Id.* at 733, 761. The Court found § 10(a) narrowly tailored to further the following compelling interests: (1) protecting children from "patently offensive" material, (2) the interest of programmers maintaining access channels, and (3) preserving the cable operators' right to make editorial decisions. *Id.* at 743. The Court pointed out that § 10(a)'s permissive nature gives cable operators the ability to rearrange programming to times that better fit the desired audience rather than ban the programming all together. *Id.* at 746.

³⁷ *Id.* at 733, 759. Although the Court recognized the government's compelling interest in protecting children from being exposed to "patently offensive" material, it found § 10(b) not narrowly tailored, not the least restrictive, and excessive. *Id.* at 755. The segregate and block provision required the operator to unblock that channel within 30 days of written request by the subscriber, and then to reblock that channel within thirty days of the subscriber's request for reblocking. *Id.* at 754. Also, leased access channel programmers were required to notify cable operators of an "intended patently offensive" program up to thirty days before its scheduled broadcast. *Id.* The Court noted that the additional cost and burden of these requirements could cause an operator to ban programming he would otherwise let run at certain times because of the costs and burdens associated with them. *Denver Area*, 518 U.S. at 754. The Court pointed out several alternatives which are less restrictive: (1) scramble or block the channel without the written access request, (2) block channels by request, (4) V-chip, or (5) lockboxes. *Id.* at 756-58.

³⁸ *Denver Area*, 518 U.S. at 766. In light of the fact that public access chan-

III. UNITED STATES V. PLAYBOY ENTERTAINMENT GROUP, INC.

A. *Opinion of the Court*

In *United States v. Playboy Entertainment Group, Inc.*,³⁹ the Supreme Court of the United States held that where a content-based restriction of speech seeks to protect children from being exposed to indecent material as a result of signal bleed, the government must prove the means chosen is the least restrictive; if not, the provision violates the First Amendment's free speech clause.⁴⁰

After examining the statute, the Court found the only reasonable way for cable operators to comply with § 505 is to time channel.⁴¹ Because § 505 regulates speech based on its content, the regulation must be narrowly tailored to promote a compelling government interest, and if there is a less restrictive alternative, it must be employed.⁴²

The Court recognized that cable television, like broadcast media, poses its own unique problems which may justify restrictions that would be invalid in other contexts.⁴³ However,

nels are already controlled and under supervision, the government failed to show this provision was necessary to protect children or that it was narrowly tailored to that end. *Id.* Cable system operators have not historically had editorial control over the programming on public access channels. *Id.* Programming on public access channels is controlled by a system of public, private, and nonprofit organizations, and this supervision normally avoids any child-related problems. *Id.* at 763.

³⁹ 120 S. Ct. 1878 (2000).

⁴⁰ *Playboy Entertainment*, 120 S. Ct. at 1886. The Court based its opinion on two important premises: (1) there are legitimate reasons for regulating the speech and (2) the speech in question is not obscene. *Id.* at 1885. The first premise is based on the fact that many adults would also find the material offensive, and the material comes into the home uninvited where children may see or hear it against their parents' wishes. *Id.* And with the material not being obscene, adults have the right to see it, and Playboy has the right to transmit it. *Id.*

⁴¹ *Id.* at 1886. However, time channeling (restricting the hours in which a program can be viewed) would impose significant restrictions on speech that is protected by the First Amendment. *Id.*

⁴² *Id.* at 1886. The speech in question is defined by its content; therefore, the statute seeking to restrict it is content-based. *Id.* at 1885. Section 505 applied only to channels dedicated to "sexually explicit adult programming or other programming that is indecent" and did not regulate signal bleed from other channels. *Id.* The Court gave notice to the district court's finding that protecting children is a compelling interest and did not refute its finding. *Id.* at 1884.

⁴³ *Id.* at 1886. The Court acknowledged that the degree of restriction allowed

the Court recognized there is one key difference between the broadcast media and cable television; cable television can "block unwanted channels on a household by household basis."⁴⁴ The Court then addressed the issue of whether a less restrictive alternative is available, in particular, whether § 504 with adequate notice would be effective in furthering the government's interest.⁴⁵ The Court found that the government did not meet their burden of showing § 504 with adequate notice would be ineffective in promoting the government's interest.⁴⁶ Not only did the government fail to prove there was not a less restrictive alternative, they also failed to show there was a "pervasive, nationwide problem justifying" § 505's restrictions.⁴⁷

The Court reiterated that because the Government failed to demonstrate § 505 was the least restrictive means of ad-

will be dependent on the medium of communication employed and the circumstances of each individual case. *Id.* at 1886-87.

⁴⁴ *Id.* at 1887. This case turned on this distinction. *Id.* The option to target block channels is less restrictive than banning; therefore, if it is feasible and effective, the government must employ it. *Id.* Target blocking would allow the government to further their interest while not violating the First Amendment. *Id.* The option to block distinguishes this case from *Pacifica Foundation. Playboy Entertainment*, 120 S. Ct. at 1887.

⁴⁵ *Playboy Entertainment*, 120 S. Ct. at 1887. There was no question that § 504 was narrowly tailored. *Id.* at 1888. The government produced no evidence to show that a publicized § 504 (voluntary blocking provision) would not be able to inform parents of the possible signal bleed of indecent material and about their option to have that channel blocked. *Id.* at 1891.

⁴⁶ *Id.* Content-based regulations are presumed invalid, and the government has the burden to rebut that presumption. *Id.* at 1888. Therefore, "when a plausible, less restrictive alternative is offered to a content-based speech restriction, it is the government's obligation to prove that the alternative will be ineffective to achieve its goals." *Id.* at 1891. To meet their burden, the government would have had to show that individual blocking would not be an effective alternative; that they did not do. *Id.* at 1889.

⁴⁷ *Id.* at 1891. The government could not show the number of households which actually experienced signal bleed; therefore, they failed to establish the actual extent of the problem. *Id.* at 1890. The government did not demonstrate how serious the problem of signal bleed is. *Id.* at 1889. They failed to produce any hard evidence as to how likely a child is to be exposed to sexual images as a result of signal bleed. *Id.* The government presented only a handful of incidents and did not present any survey type of evidence, but only estimates of potential exposure to signal bleed. *Playboy Entertainment*, 120 S. Ct. at 1890.

dressings a real problem, § 505 violated the First Amendment.⁴⁸

B. Concurring Opinion of Justice Stevens

In response to Justice Scalia's dissenting opinion, Justice Stevens argued that the fact Playboy's programs are offensive to many justified protecting statements about the content of the program.⁴⁹

C. Concurring Opinion of Justice Thomas

Although Justice Thomas was unwilling to lessen the standards of the First Amendment in order to uphold § 505, he argued that some of the programming at issue would qualify as obscene under the Miller test; therefore, the government could prohibit the broadcast.⁵⁰

D. Dissenting Opinion of Justice Breyer

First, the dissenters found children's exposure to signal bleed of adult programming is a severe problem.⁵¹ Second, the dissenters argued § 504 would not be as effective as § 505 in furthering the government's interest, and, therefore, § 504

⁴⁸ *Id.* at 1893. The Court did not find signal bleed to be a serious problem justifying a nationwide daytime speech ban. *Id.* at 1891.

⁴⁹ *Id.* at 1894 (Stevens, J., concurring). Justice Scalia argued that although the content of the program may be protected by the First Amendment, it can become obscene by the way it is advertised. *Id.* at 1894. A general principle of the First Amendment is that "information is not in itself harmful, that people will perceive their own best interests if only they are well enough informed, and that the best means to that end is to open the channels of communication rather than close them." *Id.* (Stevens, J., concurring).

⁵⁰ *Playboy Entertainment*, 120 S. Ct. at 1894-95 (Thomas, J., concurring). Because the case was litigated under the assumption that the programming is indecent, not obscene, Justice Thomas refused to take the view that the programming is obscene. *Id.* at 1895 (Thomas, J., concurring).

⁵¹ *Id.* at 1900-01 (Breyer, J., dissenting). The dissenters found that because of imperfect scrambling systems, a potential 22 million children were exposed to signal bleed. *Id.* at 1900 (Breyer, J., dissenting). They also found that because only 75% of operators were in compliance with § 505, coupled with the fact that those who did comply opted to time channel, further indicates a severe problem. *Id.* (Breyer, J., dissenting).

is not a less restrictive alternative.⁵² Given that the dissenters found a compelling interest and that § 505 is the least restrictive alternative, they concluded § 505 is lawful and consistent with the First Amendment.⁵³

E. Dissenting Opinion of Justice Scalia

Although Justice Scalia agreed with the principal dissent's findings, he found the statute could have been upheld as regulating obscenity.⁵⁴

IV. DISCUSSION

In *United States v. Playboy Entertainment Group, Inc.*, the Supreme Court emphasized that where there is a content-based restriction on speech, the government must be able to prove there is not a less restrictive alternative.⁵⁵ In the ab-

⁵² *Id.* at 1901 (Breyer, J., dissenting). "A less restrictive alternative must be at least as effective in achieving the legitimate purpose that the statute was enacted to serve." *Id.* (Breyer, J., dissenting). The dissenters distinguished § 504 and § 505 in the following manner: § 504 requires the parent to request for a channel to be blocked, while § 505 prohibits a channel from being transmitted unless the parent requested it. *Id.* (Breyer, J., dissenting). The dissenters argued that § 504 is not as effective because § 505 will prohibit adult programming from being exposed to children whose parents: (1) do not know they are being exposed to it, (2) cannot easily supervise their children, or (3) do not know about their rights under § 504. *Id.* (Breyer, J., dissenting). The dissenters also point to the fact that very few people have used § 504, and in their view, even with better notice to the subscribers, § 504 would not be as effective. *Playboy Entertainment*, 120 S. Ct. at 1902-03 (Breyer, J., dissenting).

⁵³ *Id.* at 1903 (Breyer, J., dissenting). The dissenters found § 505 restricted no more speech than necessary to promote the government's interest. *Id.*

⁵⁴ *Id.* at 1895 (Scalia, J., dissenting). A business that: "(1) offer[s] . . . hardcore sexual material, (2) as a constant and intentional objective of [its] business, [and] (3) seek[s] to promote it as such" is not protected by the First Amendment. *Id.* at 1896 (Scalia, J., dissenting). Section 505 regulates that type of business. *Id.* (Scalia, J., dissenting). He found the possibility that a channel devoted to sex would not advertise itself as such is extremely remote. *Id.* (Scalia, J., dissenting).

⁵⁵ See *supra* notes 8, 11, 22, 24, 29, 30, 40, 42 and accompanying text. This burden is premised on the fact that the speech is protected by the First Amendment, and there is a compelling state interest. See *supra* note 9. In order to be the least restrictive and survive strict scrutiny, the means employed must be narrowly tailored to further the government's interest. See *supra* notes 23, 25 and accompanying text.

sence of the government meeting this burden, the regulation will not survive strict scrutiny and will violate the First Amendment.⁵⁶

In determining whether § 505 violated the First Amendment, the Court considered the context in which § 505 was implemented.⁵⁷ Because each medium of communication is unique, the specific medium involved becomes crucial when examining the context.⁵⁸ The case turned on the fact that unlike radio broadcasts where the broadcaster cannot prevent programs from reaching individual listeners, cable operators can.⁵⁹ The restriction upheld in *Pacifica* is very similar to § 505; however, cable television's unique ability to target block allows the two decisions to be consistent.⁶⁰

The Court has consistently recognized that protecting children from indecent material is a compelling interest.⁶¹ However, the Court was unwilling to accept that the exposure of children to adult programming through signal bleed is a severe and pervasive problem that warranted the degree of restriction which § 505 imposed on speech.⁶² After balancing

⁵⁶ See *supra* notes 30, 46 and accompanying text. This burden is placed on the government because content-based restrictions on speech are presumed invalid, and it is the government's burden to rebut that presumption. See *supra* notes 30, 46 and accompanying text.

⁵⁷ See *supra* notes 10, 16 and accompanying text. Not all circumstances require the same degree of restriction to accomplish the same goals. See *supra* note 16 and accompanying text.

⁵⁸ See *supra* notes 10, 16, 31 and accompanying text. Analyzing a content-based regulation requires the Court to employ a medium-specific analysis because each medium of communication poses its own problems. See *supra* notes 10, 16, 31 and accompanying text. Whether a regulation is the least restrictive alternative depends on the medium it is restricting. See *supra* note 43 and accompanying text.

⁵⁹ See *supra* note 44 and accompanying text. Unique to the cable medium is the ability to target block channels on an individual basis. See *supra* note 44 and accompanying text.

⁶⁰ See *supra* note 44 and accompanying text. Although both *Pacifica* and *Playboy* involved time channeling, there was not a less restrictive alternative in *Pacifica* given the medium of communication. See *supra* notes 17-18 and accompanying text.

⁶¹ See *supra* notes 18, 24, 37, 42 and accompanying text. The government has a particular interest in the well being of its youth, and that interest sometimes justifies more restrictive controls. See *supra* note 18.

⁶² See *supra* notes 30, 37, 47, 48 and accompanying text. Before a restriction

the severity of the problem and the interest of the government against the restrictions imposed, the Court determined the restrictions outweighed the benefits.⁶³ If the Court had viewed signal bleed as a significant problem as did the dissent, the Court may have ruled differently and accepted the government's argument that there was not a less restrictive alternative.⁶⁴

However, the Court found that § 504 was an effective and less restrictive alternative to further the government's interest.⁶⁵ In its opinion, the Court made it clear that where a less restrictive alternative is feasible and effective in promoting the government's interest, it must be employed rather than an outright ban on speech.⁶⁶

If parents view signal bleed of adult programs as a serious problem, they can take an affirmative step and exercise their rights under § 504 without infringing on the rights of others.⁶⁷

such as § 505 can be justified, there must be some evidence of a real problem. *See supra* notes 30, 47.

⁶³ *See supra* notes 47-48 and accompanying text. The Court took a balancing approach to determine if the problem of signal bleed justified the restrictions of § 505. *See supra* note 11 and accompanying text.

⁶⁴ *See supra* note 51 and accompanying text. The dissent viewed the exposure of children to adult programming as a result of signal bleed as a serious problem, whereas the majority did not. *See supra* notes 48, 51.

⁶⁵ *See supra* notes 45-46 and accompanying text. If an individual views signal bleed as a serious problem, § 504 allows each subscriber to make an individual decision to block a particular channel, while still having the same effect that § 505 would. *See supra* notes 5, 45.

⁶⁶ *See supra* notes 41-46 and accompanying text. Banning is the most restrictive form of regulation; therefore, where there appears to be a less restrictive but effective alternative, the government must demonstrate that the alternative is not effective in furthering the government's interest. *See supra* note 46.

⁶⁷ *See supra* notes 44, 46 and accompanying text. In *Sable*, *Reno*, *Denver Area*, and *Playboy*, the Court seemed to suggest that where parents have the ability to protect their children from indecent material, the government should not impose any further restrictions. *See supra* notes 25, 31 37, 45.

V. CONCLUSION

United States v. Playboy Entertainment Group, Inc. demonstrated the high hurdle the government must satisfy for a content-based restriction on protected speech to be found constitutional and consistent with the First Amendment. Statutes imposing restrictions of this nature must be able to survive a rigorous strict scrutiny analysis. Although the government has a compelling interest in protecting its youth, there must be evidence of a serious problem which the statute is aimed to correct. Then the government must be able to demonstrate that there is not a less restrictive alternative. If the government cannot satisfy their burden, the statute will not survive strict scrutiny.

Chad Davidson

**CONSTITUTIONAL LAW – ESTABLISHMENT CLAUSE – A
POLICY ALLOWING POTENTIAL RELIGIOUS EXPRESSION AT
GOVERNMENT-SPONSORED EVENTS VIOLATES THE
ESTABLISHMENT CLAUSE IF THE GOVERNMENT ENTITY
CREATED THE POLICY WITH THE PURPOSE TO PROMOTE
RELIGIOUS BELIEFS**

I. FACTS

In October 1995, the Santa Fe Independent School District (the District), a political subdivision of Texas, adopted a policy allowing a student representative to present a statement during pre-game ceremonies at football games to promote an appropriate competitive environment.¹ Under the policy, students voted by secret ballot to determine whether the pre-game ceremonies should include a presentation of statements to solemnize the event and, if so, the student to deliver such statements.² The Court considered the policy even though no students had yet delivered messages pursuant

¹ Santa Fe Indep. Sch. Dist. v. Doe, 120 S. Ct. 2266, 2271-72 (2000). Under the supervision of the school faculty, the student would deliver the statement on school property while using the school's public address system. *Id.* at 2279.

² *Id.* at 2272. The Fifth Circuit previously upheld a similar policy permitting nonsectarian, nonproselytizing invocations and speakers at graduation ceremonies based on a majority vote of the students. *Id.* at 2274. The Circuit Court stated that nonsectarian, nonproselytizing invocations at graduation ceremonies probably do not advance religion. *Id.* However, the Fifth Circuit refused to extend this rule to school-related sporting events. *Id.* The Fifth Circuit explained that graduation differed from sporting events because graduations represented a "solemn and extraordinary event." *Sante Fe*, 120 S. Ct. at 2276. The policy provided for an annual election with the same elected student delivering the statements for the entire season. *Id.* In addition to solemnizing the football game and creating an appropriate competitive environment, the policy also stated the purposes of promoting "good sportsmanship and student safety." *Id.* at 2273 n.6. The school originally titled the policy "Prayer at Football Games." *Id.* at 2279. Elections held under this policy remained effective even after the school changed the title to "Pre-Game Ceremonies at Football Games." *Id.* at 2273 n.6.

to it.³

Prior to the adoption of the October policy, Mormon and Catholic students, with their mothers, challenged the District's previous practice of allowing a student councilman chaplain to deliver a prayer at football games and sought an injunction.⁴ They brought suit in the Federal District Court for the Southern District of Texas.⁵ Before the district court ruled on the previous practice, the District adopted the October policy.⁶

The district court accepted the October policy if modified to provide that the elected student deliver a nonsectarian, nonproselytizing prayer, if the student delivered a prayer at all.⁷ The Fifth Circuit Court of Appeals found this modified policy unconstitutional.⁸ The United States Supreme Court

³ *Id.* at 2281. However, the district had officially enacted the policy. *Id.* at 2273.

⁴ *Id.* at 2271. The respondents also claimed the District: (1) promoted attendance at a Baptist revival, (2) encouraged membership in religious clubs, (3) ridiculed children holding minority religious beliefs, (4) allowed distribution of Gideon bibles on school premises, and (5) allowed students to deliver Christian benedictions and invocations from stage at graduation ceremonies. *Id.* The district court allowed the plaintiffs to bring suit anonymously to prevent harassment. *Id.* at 2271. Continued attempts by individuals associated with the District to determine the identity of the plaintiffs prompted the district court to threaten the "harshest possible contempt sanctions." *Id.* at 2271 n.1. The district court did, however, open the trial to the public. *Doe v. Santa Fe Indep. Sch. Dist.*, 933 F. Supp. 647, 648 (S.D. Tex. 1996).

⁵ *Santa Fe*, 120 S. Ct. at 2271. The respondents sought declaratory and prospective injunctive relief in addition to money damages. *Doe v. Santa Fe Indep. Sch. Dist.*, 168 F.3d 806, 811 (5th Cir. 1999). The respondents filed the action pursuant to 42 U.S.C. § 1983. *Id.* Section 1983 holds a responsible party liable to any person injured through the deprivation of "rights, privileges or immunities secured by the Constitution and laws." 42 U.S.C. § 1983 (1996).

⁶ *Santa Fe*, 120 S. Ct. at 2271. Prior to the onset of this litigation, the district maintained no written policy governing prayer at football games. *Santa Fe*, 168 F.3d at 810.

⁷ *Santa Fe*, 120 S. Ct. at 2271. The policy did not require a prayer. *Id.* at 2273 n.6. The policy described the pre-game statement as a "brief invocation and/or message." *Id.*

⁸ *Id.* at 2271. The Fifth Circuit distinguished this case from its prior decisions allowing graduation prayers. *Santa Fe*, 168 F.3d at 822-23. In addition to different levels of solemnity between graduations and football games, the decision depended, in part, on the view that any coercion resulting from prayers at gradu-

granted certiorari and held: affirmed.⁹ The Court held that a policy allowing potential religious expression at government-sponsored events violates the Establishment Clause of the First Amendment if the government entity created the policy with the purpose to promote religious beliefs.¹⁰

II. RELATED LAW

A. *The Lemon Test*

Lemon v. Kurtzman required the Court to decide whether state programs partially funding certain religious institutions violated the Establishment Clause.¹¹ Pennsylvania and Rhode Island created statutes providing partial state funding of secular courses taught in the states' non-public religious schools.¹² The Court held the programs violated the Establishment Clause.¹³ The Court stated statutes must result from a secular legislative purpose, neither further nor restrict religion, and not produce undue entanglement of religion and government.¹⁴ The Court based its decision on excessive gov-

ations represented less of a threat because graduating high school seniors possess a level of maturity much greater than that of the younger students attending football games. *Id.*

⁹ *Santa Fe*, 120 S. Ct. at 2283. The Court limited its opinion to the issue of whether the district's policy of allowing prayer initiated and led by students at football games violates the Establishment Clause. *Id.* at 2275.

¹⁰ *Id.* The Establishment Clause of the First Amendment provides that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." U.S. CONST. amend. I.

¹¹ *Lemon v. Kurtzman*, 403 U.S. 602, 606 (1971).

¹² *Id.* at 606-07. The Pennsylvania statute provided funding through reimbursement for teacher's salaries, books, and other material in certain secular subjects. *Id.* The Rhode Island statute provided a direct 15% salary supplement for teachers of secular courses. *Id.* at 607. With regard to a potential impermissible government purpose, the Court deferred to the Rhode Island statute's stated legislative purpose to protect the quality of education in private elementary schools. *Id.* at 607. *But see* Michael A. Berg, Note, *The Religious Right, Constitutional Values and the Lemon Test*, 95 ANN. SURV. AM. L. 37, 73 (1995) (claiming that in anticipation of Establishment Clause challenges, legislators often mask religious motivations with secular terms).

¹³ *Lemon*, 403 U.S. at 625. Though the Court used this decision to announce a new three-part Establishment Clause test, the holding rested primarily on only one prong of the test, impermissible government entanglement. *Id.*

¹⁴ *Id.* at 612-13. Various Supreme Court opinions criticize this test as not

ernment entanglement produced by the extensive state administrative and financial resources needed to administer the programs.¹⁵

B. Permissible Government Purpose

Lynch v. Donnelly brought the issue of a city's inclusion of a nativity scene in its Christmas display before the Court.¹⁶ Certain residents of the city claimed that a nativity scene displayed by the city each year operated to endorse religious beliefs.¹⁷ The Court held the display of the nativity scene did

providing a workable doctrine. See, e.g., *Wallace v. Jaffree*, 472 U.S. 38, 68-70 (1985) (O'Connor, J., concurring) (calling for refinement and reexamination of *Lemon's* three-part test); *Committee for Pub. Ed. and Religious Liberty v. Regan*, 444 U.S. 646, 671 (1980) (Stevens, J., dissenting) (describing *Lemon's* boundary between government and religion as "blurred, indistinct and variable"). In *Lynch v. Donnelly*, the Court stated that its Establishment Clause analysis did not rest on any single test, including *Lemon*. 465 U.S. 668, 679 (1984); see also Melissa M. Feldmeir, Casenote, *Amazing Disgrace: The Sin and Salvation of Rosenberger v. The University of Virginia*, 65 U. CIN. L. REV. 293, 298 (1996) (describing erosion of Supreme Court's reliance on *Lemon's* three-pronged test). Justice Scalia strongly questioned *Lemon's* continued precedential value by stating that "after being repeatedly killed and buried, *Lemon* stalks our Establishment Clause jurisprudence once again, frightening the little children and school attorneys." *Lamb's Chapel v. Center Moriches Union Free Sch. Dist.*, 508 U.S. 384, 398 (1993) (Scalia, J., concurring). Justice Powell, however, called the *Lemon* test the only coherent Establishment Clause test ever devised by a majority of the Court. *Wallace*, 472 U.S. at 63 (Powell, J., concurring). He warned that continued criticism by the Court of the *Lemon* test might encourage lower courts to decide Establishment Clause cases on an ad hoc basis. *Id.*; see also David Felson, Comment, *Developments in Approaches to Establishment Clause Analysis: Consistency for the Future*, 38 AM. U. L. REV. 395, 396 (1989) (noting that changes in Establishment Clause doctrines and analytical structures force courts to utilize ad hoc approaches to resolve Establishment Clause controversies).

¹⁵ *Lemon*, 403 U.S. at 621-22. The Court also warned that political fighting over scarce state resources channeled to religious institutions may cause political divisions along religious lines. *Id.* at 622. Such a situation presents one of the primary evils that the First Amendment seeks to protect. *Id.*; see Paul A. Freund, *Public Aid to Parochial Schools*, 82 HARV. L. REV. 1680, 1692 (1969) (describing unique nature of conflict between religion and politics).

¹⁶ *Lynch v. Donnelly*, 465 U.S. 668, 671 (1984). The Court noted hundreds of towns erect similar displays. *Id.*

¹⁷ *Id.* at 672. Plaintiffs also included individual members of the Rhode Island arm of the American Civil Liberties Union as well as the affiliate itself. *Id.* at 671. The Court stated that endorsement of a religious faith violates the Establish-

not violate the Establishment Clause.¹⁸ The nativity scene, viewed in the context of other secular Christmas symbols located nearby, did not present sufficient evidence that the government intended to use it to advocate a particular religious message.¹⁹

ment Clause, but giving special recognition to religion in general or to one faith does not necessarily produce constitutional injury. *Id.* at 678; see *Walz v. Tax Comm'n of New York*, 397 U.S. 664, 671 (1970) (stating that interpreting religion clauses of Constitution literally undermines true meaning of such clauses as revealed by history).

¹⁸ *Lynch*, 465 U.S. at 687. Many lower courts did not extend this decision to other religious symbols primarily because the symbols lacked the surrounding secular displays of *Lynch*. See, e.g., *Indiana Civil Liberties Union, Inc. v. O'Bannon*, No. 1800-0811-C-B/S, 2000 WL 1044864, at *12 (S.D. Ind. July 28, 2000) (holding proposed monument on statehouse grounds depicting Ten Commandments did not possess dual secular and religious symbolism of nativity scene in *Lynch* because nativity scene of *Lynch* appeared among secular symbols of Santa and Christmas trees); *Amancio v. Town of Somerset*, 28 F. Supp. 2d 677, 681 (D. Mass. 1998) (concluding nativity scene erected by municipality possessed only religious meaning because its surroundings lacked "winter wonderland" atmosphere described in *Lynch* where secular symbols appeared as prominently as religious symbols); *ACLU of Miss. v. Mississippi State Gen. Serv. Admin.*, 652 F. Supp. 380, 384 (S.D. Miss. 1987) (holding Latin cross placed on side of state building represented exclusively sectarian symbol lacking significance in any national holiday's historical tradition). See generally Joshua Z. Darrow, Comment, *Of Crosses and Crèches: The Establishment Clause and Publicly Sponsored Displays of Religious Symbols*, 35 AM. U. L. REV. 477 (1986) (discussing application of traditional Establishment Clause doctrines to religious symbols displayed on public property).

¹⁹ *Lynch*, 465 U.S. at 690-91 (O'Connor, J., concurring); see also *Wallace*, 472 U.S. at 74-75 (mandating deference to enactment's stated, plausible secular intent); *Meuller v. Allen*, 463 U.S. 388, 394-395 (1983) (articulating Court's reluctance to infer unconstitutional motive for statutes appearing to address secular concerns). The Court stated that when individuals perceive the government to endorse a religious message contrary to their own beliefs, they consider themselves "outsiders, not full members of the political community." *Lynch*, 465 U.S. at 688; see also Leah G. Morgenstein, Note, *Board of Education of Westside Community Schools v. Mergen: Three "R's" Religion = Mergens*, 41 AM. U. L. REV. 221, 227 (1991) (explaining that Establishment Clause violation occurs when government appears to make religion relevant to political standing).

C. Impermissible Government Purpose

In *Wallace v. Jaffree*, the Supreme Court addressed whether a statute, passed but not yet implemented, requiring a one-minute moment of silence in public schools violated the Establishment Clause.²⁰ Parents of children in the Alabama public school system challenged the statute on the basis that it promoted religion.²¹ The Court held the statute unconstitutional.²² The Court concluded the Alabama legislature enacted the statute for the purpose of endorsing religion in violation of the Establishment Clause of the First Amendment.²³

D. The Public Forum

The Supreme Court in *Hazelwood School District v. Kuhlmeier* considered whether a public high school created a public forum when it established a newspaper written by

²⁰ *Wallace v. Jaffree*, 472 U.S. 38, 41-42 (1985).

²¹ *Id.* at 42. The original complaint also alleged the plaintiff's children experienced ostracism when they refused to participate in a daily prayer led by the teachers and recited by the other children. *Id.*

²² *Id.* at 61. Legislators elected by majority vote passed the statute. *Id.* at 56-60. Likewise, in *Board of Regents of University of Wisconsin System v. Southworth*, a majority vote of students determined whether certain expressive activities received school benefits. 120 S. Ct. 1346, 1351 (2000). The Court held that elections do not protect minority views. *Id.* at 1357; see also *West Va. Bd. of Educ. v. Barnette*, 319 U.S. 624, 638-40 (1943) (stating that fundamental rights do not depend on outcome of elections).

²³ *Wallace*, 472 U.S. at 56-61. The Court stated its decision rested on the key question of "whether the government intends to convey a message of endorsement or disapproval of religion." *Id.*; see *Committee for Pub. Ed. and Religious Liberty v. Nyquist*, 413 U.S. 756, 792-93 (1973) (stating that government must pursue position of neutrality with regard to religion). This concept appears more strictly applied to situations involving children. See *Barnette*, 319 U.S. at 637 (stating student's constitutional freedoms while at school require "scrupulous protection" because schools educate students for citizenship). See generally Pamela Coyle, *The Prayer Pendulum*, A.B.A. J., Jan. 1995, at 62 (analyzing debate over voluntary school prayer). The Court also held, even absent actual endorsement of religion, perceived endorsement based on "the text, legislative history, and implementation of the statute" may cause invalidation under the Establishment Clause. *Wallace*, 472 U.S. at 76. Schools had not yet implemented the statute at the time the Court considered it. *Id.* at 61. But see *Bowen v. Kendrick*, 487 U.S. 589, 612 (1988) (noting that potential constitutional injuries caused by policies under some "conceivable set of circumstances" present no basis for complete invalidation).

students.²⁴ Former student writers characterized the newspaper as a public forum and claimed the school principal violated their First Amendment rights when he, acting in an editorial capacity consistent with the school's policy, deleted certain articles.²⁵ The Court held the newspaper did not represent a public forum.²⁶ The policy of granting the principal final authority over the content of the newspaper indicated the school did not intend to open the newspaper to indiscriminate use by the students.²⁷

²⁴ *Hazelwood Sch. Dist. v. Kuhlmeier*, 484 U.S. 260, 267 (1988). The Free Exercise and Free Speech Clauses protect private speech delivered from public forums. *See Board of Educ. v. Mergens*, 496 U.S. 226, 237-43 (describing constitutional protections of private speech). The Free Exercise Clause of the First Amendment prevents the government from passing laws "prohibiting the free exercise" of religion. U.S. CONST. amend. I. The Free Speech Clause of the First Amendment prohibits the passage of laws "abridging the freedom of speech." *Id.*

²⁵ *Hazelwood*, 484 U.S. at 267-70. One article concerned teen pregnancy, and the other discussed how divorce affected certain students. *Id.* at 263. A publishing deadline prevented the principal and journalism teacher from discussing their apprehensions about the articles with the student writers prior to publication. *Id.* at 263-264.

²⁶ *Id.* at 270. The Court also held that the principal did not violate the students' speech rights. *Id.* at 273. The Court stated that educators may exercise control over the content of student speech presented as part of school-sponsored activities if the educator's actions relate to legitimate academic concerns. *Id.*; *see also* Darrel Jackson, Comment, *The Constitution Expelled: What Remains of Students' Fourth Amendment Rights?*, 28 ARIZ. ST. L.J. 673, 674-75 (1996) (explaining Supreme Court's view that schools may place restrictions on student speech because students are children placed in state's care).

²⁷ *Hazelwood*, 484 U.S. at 271-72. The Court stated public forums arise in two situations. *Id.* at 267. First, traditional public forums exist where a public place, such as streets, parks, etc., historically provided a place to assemble, communicate ideas and discuss public subjects. *Id.*; *see* Capitol Square Review and Advisory Bd. v. Pinette, 515 U.S. 753, 757 (1995) (concluding Ku Klux Klan cross placed in Ohio's statehouse plaza did not violate Establishment Clause as plaza constituted traditional public forum where various religious and secular events historically took place); *Hague v. CIO*, 307 U.S. 496, 515 (1939) (invalidating New Jersey ordinance used to prohibit assembly and speeches presented on streets and in public parks by individuals espousing communist views). Second, government entities create limited public forums when they allow "by policy or by practice . . . indiscriminate use" of their facilities by the general public or some subsection of it. *Hazelwood*, 484 U.S. at 267; *see* *Perry Educ. Ass'n v. Perry Local Educators' Ass'n*, 460 U.S. 37, 47 (1983) (deciding that school district's mail system did not constitute public forum because school district did not open it to indiscriminate public use, even though the school allowed various private organi-

E. Impermissible Government Coercion

The Supreme Court in *Lee v. Weisman* considered whether prayer included as part of a public middle school's graduation ceremony violated the Establishment Clause, even though the school did not require attendance.²⁸ In *Lee*, a rabbi, at the request of the school's principal, delivered a nonsectarian prayer as part of a graduation ceremony.²⁹ The Court held that prayers offered by clergy as part of a public school's graduation ceremony violate the Establishment Clause of the First Amendment.³⁰ Forcing students to choose between not attending their own graduation or attending and participating in a religious ceremony constitutes impermissible government coercion.³¹

zations access to it); *cf.* *Ysleta Fed'n of Teachers v. Ysleta Indep. Sch. Dist.* 720 F.2d 1429, 1433-35 (5th Cir. 1983) (concluding that public school district's mail system was limited public forum because district's policy opened it to all employee organizations). Government does not create public forums when it only permits limited discourse. *See* *Cornelius v. NAACP Legal Defense & Educ. Fund, Inc.*, 473 U.S. 788, 802 (1985) (explaining that public forums do not arise from government inaction or government permission of limited discourse). Public forums, while conferring constitutional protection for speech delivered from them, may still come under Establishment Clause scrutiny. *See* *Pinette*, 515 U.S. at 772 (O'Connor, J., concurring) (refusing to regard public forums as immune from Establishment Clause scrutiny).

²⁸ *Lee v. Weisman*, 505 U.S. 577, 580 (1992).

²⁹ *Id.* at 581. At the time of this decision, the public school system in Providence, Rhode Island, where the events occurred, permitted all principals to invite clergy to "give invocations and benedictions" at graduation ceremonies. *Id.*

³⁰ *Id.* at 631. Several lower courts refused to extend this holding in only slightly different situations. *See, e.g.,* *Tanford v. Brand*, 883 F. Supp. 1231, 1245 (S.D. Ind. 1995) (concluding that invocations and benedictions at law school graduations did not violate Establishment Clause because college educated students and adults require less protection than younger, more impressionable students); *Bauchman v. West High Sch.*, 900 F. Supp. 248, 251 (D. Utah 1995) (stating that songs with religious content sung at high school graduations had sufficiently secular purpose to protect sophomore voluntarily attending from constitutional injury); *Adler v. Duval County Sch. Bd.*, 851 F. Supp. 446, 451 (M.D. Fla. 1994) (holding graduation policy providing for student-led messages with content decided by students did not violate First Amendment).

³¹ *Lee*, 505 U.S. at 594-95; *see also* *School Dist. of Abington v. Schempp*, 374 U.S. 203, 224-25 (1963) (holding that allowing students to voluntarily excuse themselves from daily prayers did not shield practice of daily prayers from Establishment Clause violation); *cf. Marsh v. Chambers*, 463 U.S. 783, 792 (1983) (stat-

III. SANTA FE INDEPENDENT SCHOOL DISTRICT V. DOE

A. *Opinion of the Court*

In *Santa Fe Independent School District v. Doe*,³² the Supreme Court held that a public high school's policy of allowing a student to deliver pre-game statements to solemnize football games violated the First Amendment's prohibition against government established religion.³³

ing voluntary prayer in state legislature did not impermissibly coerce because adult legislators frequently entered and left for various reasons and with little or no comment). The Court explained that the Constitution prohibits government use of social pressure to promote adherence to religious beliefs in the same way that it prohibits the use of more direct methods. *Lee*, 505 U.S. at 594. The Court noted state entanglement in the ceremony extended to control of the content of the prayer through a pamphlet given to the rabbi prior to the graduation titled "Guidelines for Civic Occasions." *Id.* at 588; see *Engel v. Vitale*, 370 U.S. 421, 425 (1962) (concluding government may not compose prayers for citizens to recite as part of any government sponsored religious program). But see *Bethel Sch. Dist. No. 403 v. Fraser*, 478 U.S. 675, 685 (1986) (concluding that nothing in Constitution prohibits schools from limiting content of speeches given by students to prevent use of lewd or vulgar language). The Court agreed that a non-sectarian prayer of the type endorsed by the school makes the prayer more palatable to those of differing religions. *Lee*, 505 U.S. at 588. A primary issue, however, in determining violations of the Establishment Clause rests on whether the government undertook to produce a prayer as part of a formal religious exercise that students felt compelled to attend. *Id.* at 588-89. In explaining the rationale for rejecting any forced period of silence for prayer, the Court noted psychological research supporting the notion of the strong influence social convention places on adolescents to conform. *Id.* at 593-94. The Court also stated non-sectarian prayers may appeal to more people in the audience, but the offense to those opposed to the prayer still exists. *Id.* at 594. Indeed, the non-sectarian nature of the prayer may serve to accentuate feelings of "isolation and affront." *Id.* Additionally, the Court stated that the Establishment Clause prohibited any action by the government that establishes a religion "or tends to do so." *Lee*, 505 U.S. at 587. However, government toleration of religion is not coercive as long as the government does not favor any particular religion in any particular way. See Lynne A. Rafalowski, Note, *Can Public Schools Really Permit Religious Speech Without Promoting Religion? The Struggle to Accommodate But Not Establish Religion in Chandler v. James*, 45 VILL. L. REV. 547, 575-76 (2000) (stating government toleration does not necessarily equal government coercion). See generally Daniel N. McPherson, *Student-Initiated Religious Expression in the Public Schools: The Need for a Wider Opening in the Schoolhouse Gate*, 30 CREIGHTON L. REV. 393 (1997) (describing how schools provide obvious conflict between Free Exercise and Establishment Clauses).

³² 120 S. Ct. 2266 (2000).

³³ *Id.* at 2275. The Court stated the principles articulated in *Lee* guided its

The Court first considered whether the school's policy created a public forum.³⁴ The Court stated that the District indicated no intention of allowing indiscriminate use of the pregame ceremonies for statements by the student body generally.³⁵ Instead, one student was to deliver a message, limited in content by the policy, for the entire season.³⁶ The Court concluded, therefore, the District did not create a public forum, and any religious message delivered pursuant to the policy represented government speech in violation of the Establishment Clause.³⁷

The Court next examined the argument by the District that it had sufficiently distanced itself from involvement with any religious content potentially arising in the pregame messages.³⁸ The Court indicated that the District impermissibly entangled itself with and encouraged religious messages.³⁹

analysis. *Id.*

³⁴ *Id.* at 2275-76. Even though the District relied on several public forum cases, it never actually argued that its policy created a public forum. *Id.* at 2276 n.12.

³⁵ *Id.* at 2276. The Court stated that practice or policy may indicate the intent to allow indiscriminate use. *Id.* The District had not yet utilized the policy. *Id.* at 2281. The District, therefore, had no opportunity to show any sort of practice pursuant to the policy. *Id.*

³⁶ *Id.* at 2276. The policy provided that the statements should serve "to solemnize the event, to promote good sportsmanship and student safety, and to establish the appropriate environment for the competition." *Id.* at 2273 n.6. The policy also stated that if a court enjoined it, then a new policy allowing only nonproselytizing and nonsectarian messages would become effective. *Id.* Allowing only one student at a time access to the forum, the Court noted, did not necessarily preclude public forum status. *Id.* at 2276. The majoritarian election, however, ensured that students would never hear minority views as part of the ceremonies. *Sante Fe*, 120 S. Ct. at 2276.

³⁷ *Sante Fe*, 120 S. Ct. at 2275. The Court acknowledged that if the District did create a public forum, then the Free Speech and Free Exercise Clauses prohibited government suppression of any religious speech delivered from it. *Id.* A public forum, however, does not act as an absolute shield against scrutiny under the Establishment Clause. *Id.* at 2276 n.13.

³⁸ *Id.* at 2277. Specifically, the District described its policy as neutral and stated the elected student acted as a "circuit breaker" between the school and the message delivered. *Id.*

³⁹ *Id.* The Court considered the two-step election process as inadequate to disentangle the school from religious messages. *Id.* The Court recognized the importance many communities place on public worship, and the genuine desire to use

The language of the policy itself, the Court noted, revealed a high level of entanglement because the District permitted the messages and mandated the elections.⁴⁰ The Court considered the policy's reference to "invocation" and its stated purpose "to solemnize the event" as promoting religious messages, especially when viewed in light of the school's religious history.⁴¹

The Court rejected the District's assertion that the policy did not produce unconstitutional coercion.⁴² The District contended the policy did not coerce because (1) the students chose the messages, and (2) the school did not require attendance at football games.⁴³ The Court claimed the election mechanism used to determine the students' choice created divisions in the student body along religious lines in violation of the Establishment Clause.⁴⁴ Voluntary attendance, the Court stated, did not alleviate the coercive nature of the policy.⁴⁵ The policy still required students to choose between potentially partici-

prayer to indicate an event's significance. *Id.* at 2278.

⁴⁰ *Id.* at 2277. The fact that students would deliver messages on school property, over a school broadcasting system and at a school-sponsored event also supported the Court's position of impermissible entanglement. *Id.* at 2275.

⁴¹ *Id.* at 2277-78. The Court explained that most people consider an "invocation" as an appeal to God. *Id.* at 2277. The Court also felt that religious messages are the most apparent method of solemnization. *Id.* Still, even if the school did not actually intend to endorse religion, the mere perception of such intention serves to invalidate the policy. *Id.* at 2278. To support the notion of a perceived endorsement, the Court pointed to: (1) the delivery of the message in the context of all of the school symbols typically displayed at the games, (2) the school's history of endorsing religion and (3) the evolution of the policy itself. *Santa Fe*, 120 S. Ct at 2278-79.

⁴² *Santa Fe*, 120 S. Ct. at 2281. The Court carefully noted the Constitution prohibits only religious practices coerced by the government. *Id.* Nothing in the Constitution prohibits voluntary religious expression by students "before, during, or after the school day." *Id.*

⁴³ *Id.* at 2279. Though this case primarily involves students, the Court held that all people present, students and adults alike, suffer constitutional injury when a school broadcasts prayers at its football game. *Id.*

⁴⁴ *Id.* at 2280. The Court suggests, however, such elections do not necessarily violate the Constitution. *Id.* Rather, the history of religious controversy surrounding this particular policy caused the impermissible coercion. *Id.*

⁴⁵ *Id.* The Court also noted that the District did require the attendance of certain students, such as band members, cheerleaders and football players. *Id.* at 2280-81.

pating in a religious exercise or not attending the popular high school activity of American football.⁴⁶ Requiring such a choice, the Court concluded, violates the First Amendment.⁴⁷

Finally, the Court rejected the District's contention that the respondents brought their challenge prematurely as no student had yet delivered a message, religious or otherwise, under the policy.⁴⁸ The Court explained that two events had already occurred that violated the Establishment Clause.⁴⁹ First, enactment of the policy, alone, indicated intent, or at least a perceived intent, by the District to promote religion.⁵⁰ Second, the District had unconstitutionally subjected the issue of prayer to a government-sponsored election.⁵¹

B. Dissenting Opinion

The dissenting justices criticized the Court's opinion as inconsistent with the meaning of the Establishment Clause and openly hostile to any aspect of religion in public life.⁵²

⁴⁶ *Id.* The Court stated government use of social pressure to advance a religion produces a constitutional injury as serious as that produced by more direct means. *Id.*

⁴⁷ *Santa Fe*, 120 S. Ct. at 2280-81. The First Amendment, the Court asserted, requires that the government not force citizens to surrender their rights because they refuse to participate in a religious ceremony. *Id.*

⁴⁸ *Id.* at 2281. The District argued that, once given the opportunity, the elected student may choose not to deliver a religious message. *Id.* at 2280-81.

⁴⁹ *Id.* at 2281-82. Forcing a student to participate in a religious ceremony represents only one type of constitutional injury that concerns the Court. *Id.* at 2282.

⁵⁰ *Id.* at 2281-82. The Court explained their previous Establishment Clause cases centered both on the unconstitutional application and unconstitutional purpose of statutes. *Id.* Again, the Court reiterated the importance of the history of the development of the policy and the history of the District itself to the Court's discernment of the true religious nature of the policy. *Id.* at 2282. The Court defended this approach by stating that a sound Establishment Clause decision mandates the consideration of all surrounding circumstances. *Id.* The Court noted the District's "long-established tradition" of allowing student-led prayer at football games. *Santa Fe*, 120 S. Ct. at 2282. The Court believed the District asked it to "pretend" that the policy was not about prayer. *Id.*

⁵¹ *Id.* The Court felt the election transformed the school into a place of religious debate. *Id.* at 2283. The mere grant of power, the Court held, by the District to a majority-elected student to subject students holding minority views to religious messages violates the Constitution. *Id.*

⁵² *Santa Fe*, 120 S. Ct. at 2283 (Rehnquist, J., dissenting). The dissent noted

The Court's strict application of the highly criticized *Lemon* test, the dissenting justices observed, ignored more recent decisions explicitly requiring an unconstitutional application before holding a policy invalid.⁵³ The dissenters then stated that even if *Lemon* represents the appropriate test, the Court incorrectly applied it to invalidate the policy on the basis of the majoritarian election and the view that the policy results from an actual and perceived impermissible purpose.⁵⁴ The Court, the dissenters claimed, incorrectly characterized the election as about religion, instead of its stated purpose of allowing students to decide whether pre-game ceremonies should include a student speaker.⁵⁵ The dissenters accused the Court of failing to follow precedent by showing no deference to the policy's stated secular intent.⁵⁶ The dissenters

that far from a disingenuous attempt to skirt Establishment Clause prohibitions, the policy actually represents a good faith effort to comply with governing constitutional law. *Id.* at 2286-87 (Rehnquist J., dissenting).

⁵³ *Id.* at 2284-85 (Rehnquist, J., dissenting). The dissent stated that the mere possibility of an endorsement of religion does not provide a basis for restrictions on speech. *Id.* at 2284. (Rehnquist, J. dissenting). The dissent accused the Court of "venturing into the realm of prophesy" by deciding the policy will inevitably produce an unconstitutional endorsement of religion. *Id.* (Rehnquist, J., dissenting). The dissent went to great lengths to show that *Lemon*, at best, provides only a general guide for Establishment Clause inquiries. *Id.* at 2284-85 (Rehnquist, J., dissenting).

⁵⁴ *Id.* at 2285 (Rehnquist, J., dissenting). The dissent indulged in this application of *Lemon* even though it claimed the Court held *Lemon* not binding in prior decisions. *Id.* (Rehnquist, J., dissenting).

⁵⁵ *Id.* (Rehnquist, J., dissenting). The dissent listed possible results of the policy that would not violate the Establishment Clause. *Id.* at 2285-86 (Rehnquist, J., dissenting). First, the students might decide against student speakers as part of pre-game ceremonies. *Id.* (Rehnquist, J., dissenting). Second, the elections might not center on prayer, but the candidate's popularity or speaking ability. *Id.* (Rehnquist, J., dissenting). The dissent criticized the Court's assertion that simply allowing an elected student the opportunity to pray violates the Establishment Clause. *Santa Fe*, 120 S. Ct. at 2285 (Rehnquist, J., dissenting). Such a holding invalidates any policy providing an elected student, for example a student body president, the opportunity to speak because the student may choose to pray or say something religious. *Id.* (Rehnquist, J., dissenting).

⁵⁶ *Id.* at 2286 (Rehnquist, J., dissenting). The dissent accused the majority of open hostility toward the stated purpose of the policy. *Id.* (Rehnquist, J., dissenting). The dissent supported this accusation by noting the Court's use of the word "sham" to describe the stated intent of the policy. *Id.* (Rehnquist, J., dissenting).

acknowledged, however, that had the policy actually resulted in students choosing to pray at most of the games, they too might agree to invalidate the policy.⁵⁷

IV. DISCUSSION

Sante Fe Independent School District v. Doe does little to clarify the current confused state of Establishment Clause jurisprudence.⁵⁸ Contrary to previous precedent, the Court showed little deference to the policy's stated purpose.⁵⁹ Instead, the Court relied primarily on the history of the school, leaving other schools with similar histories the dilemma of how to divorce their policies from their religious past.⁶⁰ The Court's decision rests heavily on *Lee*, despite significant differences between the two cases, especially with regard to the person delivering the message and the level of control the school exercised over its content.⁶¹

The Court's view that prayer provides the only credible way of solemnizing an event struck the dissenters as "strange." *Id.* (Rehnquist, J., dissenting). The dissent addressed the use of "invocation" by stating it represents only one type of message allowed under the policy. *Santa Fe*, 120 S. Ct. at 2286 n.4 (Rehnquist, J., dissenting). The Court, the dissent observed, even acknowledged that the Free Exercise Clause requires that the government protect the right of a private student to choose to deliver a religious invocation. *Id.* at 2286 (Rehnquist, J., dissenting).

⁵⁷ *Santa Fe*, 120 S. Ct. at 2285 (Rehnquist, J., dissenting). The dissent suggested that if the policy resulted in a "Christian prayer before 90 percent of the football games," then they might also hold the policy invalid. *Id.* (Rehnquist, J., dissenting).

⁵⁸ See *supra* notes 14, 53-54 and accompanying text. Disputes about the precedential value of *Lemon* continue. See *supra* notes 53-54 and accompanying text.

⁵⁹ See *supra* notes 1, 2, 12, 19, 41 and accompanying text. The dissent stressed this represented an obvious departure from precedent. See *supra* note 56 and accompanying text.

⁶⁰ See *supra* notes 22, 41, 44, 50 and accompanying text. The Court defended its reliance on the school's history by noting that precedent mandated its consideration of all circumstances surrounding potential Establishment Clause violations. See *supra* note 50 and accompanying text.

⁶¹ See *supra* notes 2, 29, 31, 33 and accompanying text. *Lee* primarily concerns coercion, but also contains broad language interpreting the Establishment Clause to prohibit any government action that "tends" to establish religion. See *supra* note 31 and accompanying text.

The Court did, however, provide clear guidance on two points that will certainly affect the nature of a variety of school policies.⁶² First, majoritarian elections on potentially religious subjects enhance, rather than alleviate, constitutional injury.⁶³ Second, the voluntary nature of a school-sponsored activity does nothing to eliminate unconstitutional coercion with regard to the Establishment Clause.⁶⁴

Even though the Court mentioned *Lemon* only briefly, the dissenting justices took the opportunity to add to the many criticisms already plaguing that landmark decision.⁶⁵ Further, and most significantly, the dissenters suggested that had the policy, as applied, resulted in prayers at the majority of the games, then they might agree with the Court to invalidate it.⁶⁶

V. CONCLUSION

Sante Fe Independent School District v. Doe provides a broad prohibition of all policies implemented by a public entity potentially interpreted as prompted by any sort of religious purpose. Plaintiffs need not wait to determine whether violations will occur. Potential violations provide a basis for suit.

⁶² See *supra* notes 22, 31, 42-47 and accompanying text. These violations, however, all rest upon the Court's characterization of the policy as religious. See *supra* notes 41, 55 and accompanying text.

⁶³ See *supra* notes 1, 22, 44 and accompanying text. The dissenting justices argued the majoritarian election might not result in religious divisions, but instead, focus on the popularity and quality of the individual speakers. See *supra* note 55 and accompanying text.

⁶⁴ See *supra* notes 31, 43, 45-47 and accompanying text. Even if attendance at a school-sponsored event is not voluntary, social pressure to attend serves to impermissibly coerce. See *supra* notes 14, 31 and accompanying text.

⁶⁵ See *supra* note 14, 53 and accompanying text. However, even the dissent stated that *Lemon* provides a general guide for Establishment Clause cases. See *supra* note 53 and accompanying text.

⁶⁶ See *supra* note 57 and accompanying text. This statement by the dissenters suggests that they also did not believe the policy created a public forum. See *supra* notes 24, 27 and accompanying text. If the policy did create a public forum, the Free Speech and Free Exercise Clauses would protect a student's choice to deliver prayers at all football games. See *supra* notes 24, 27 and accompanying text.

Neither majoritarian vote, nor voluntary attendance prevents Establishment Clause violation. Ultimately, though, the decision does not provide a cohesive framework that public entities may use to guard against Establishment Clause violations.

Brian Kimball

COMMUNITY BANK

Biloxi • Brandon • Calhoun • Ellisville • Flowood • Forest • Gulfport
Hattiesburg • Hernando • Indianola • Jackson • Laurel • Meridian
Ocean Springs • Olive Branch • Raleigh • Sandersville • Southaven

Member FDIC



